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A Critical Analysis of a Goods and Services Tax in Hong Kong

A project submitted to Middlesex University
in partial fulfilment of the requirements
for the degree of
Doctor of Professional Studies

Raymond Yeung

National Centre for Work Based Learning Partnerships

Middlesex University

February 2010

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ABBREVIATIONS

CGA-HK	:	Canadian Certified General Accountants of Hong Kong Association
GDP	:	Gross Domestic Product
GNP	:	Gross National Product
GST	:	Goods and Services Tax
HKICPA	:	Hong Kong Institute of Certified Public Accountants
HKSAR	:	Hong Kong Special Administrative Region
HKTI	:	Hong Kong Taxation Institute
LEGCO	:	Legislative Council of Hong Kong
OECD	:	Organisation for Economic and Cooperation Development
SARS	:	Severe Acute Respiratory Syndrome
SCMP	:	South China Morning Post
VAT	:	Value Added Tax
WHO	:	World Health Organisation
WTO	:	World Trade Organisation

PREFACE

After graduating from Essex University with a Bachelor degree in Accountancy, Finance and Economics in 1982, I worked as a senior managerial executive for a decade and as a public accountant for another decade. Even though an accountant's work is different from an economist's, business people used to ask their accountants' opinion on the economic trend. One reason is that accountants are working with money matters, which are key elements of an economy. Another reason is that business people believe accountants learn updated information of the business environment, which reflects the economy and its trend, from their clients through their daily contacts. This project is a reflection of my prior certificated and uncertificated learning in economics, accountancy studies, analytical skills and work based learning studies. The economic studies in my Bachelor degree gave me the basic analytical skill in reading economic literatures, my professional accounting practice provided me with the opportunity to apply my literal learning, either taught or self-directed, in real life. People ask accountants to express their view on the economy is not completely inappropriate. Accountants are really on the front line of the economy. However, it depends on whether they take a macro view to analyse the "data" received from the business critically. The work based learning studies enhanced my analytical and learning-to-learn skill. It let me realise that there are rich sources of knowledge in our real life and our workplace. More important, it enhanced my research capability and critical thinking: a process from identifying problems, through the collection of data and critical analysis, to draw conclusions. However, my existing knowledge and interest of discovery alone would not make me undertake a doctorate degree. At least, it could not make me commit several years' time to add a title to my name. The major force to do the doctoral degree is my aim to contribute something new to the innovative studies and my existing multi-disciplinary knowledge – economics, law, accounting and work based learning studies.

“A Critical Analysis of a Goods and Services Tax for Hong Kong”

SUMMARY

This project investigates the views of accountants in Hong Kong on the proposed Goods and Services Tax (“GST”). It also analyses the overall economy of Hong Kong in the past 60 years, focusing on the public finance system and the tax bases. The Hong Kong economy and its economic policies have been overviewed. The deficits after 1997 are found not to be structural. The tax base is also found not to be narrow as there are various types of taxes hidden in people’s daily life and consumptions. This explains the reasons that Hong Kong obtained a surplus for 48 years out of the past 60 years and accumulated a huge fiscal reserve.

A survey was conducted and the result revealed that 62% of accountants were against the GST. Even though the response rate is low, the sample size lies in the range of 5% to 6% level of precision at 95% confidence. The Hong Kong Institute of Certified Public Accountants (“HKICPA”) conducted another survey on the GST after the result of this project had been publicly released. The result was consistent with the findings of this project i.e. about 59% of accountants objected the GST. The result of the survey was widely publicised and reported by the media. It provided some references for the Government whether the GST was really needed and whether accountants supported the GST. To a large extent, it caused the Government to set aside the GST consultation in September 2006 and suspend the implementation of the GST.

CHAPTER 1

INTRODUCTION

1.1 BACKGROUNDS

Years ago when the Hong Kong Special Administrative Region (“HKSAR”) Government expressed its intention to implement a GST, a tax partner of an international accounting firm told me that he had prepared for a GST in Hong Kong as it would be a big business for the profession. This tax partner was himself against GST since he was of the view that a GST would damage the economy. In a recent discussion of the tax after the Government released the *“Broadening the Tax Base, Ensuring our future Prosperity – What’s the Best Option for Hong Kong?”* (“GST Consultation Paper”), the tax partner is now working in the financial sector and is no longer in public practice, he still insists that Hong Kong does not need the direct consumption tax as our tax base is not narrow and our economy runs well under the current system. I agree with his view even though the economy is slowing down and there were financial deficits in a few years after 1997.

What was the economy of Hong Kong like before 1997? Jonathan Dimbleby has a good description in his book *“The Last Governor”*:

“Hong Kong brags shamelessly. In all Asia it lays claim to the boldest tycoons, the best-educated and most industrious workers, the most important financial centre, the most innovative trading houses, the highest living standards, the most billionaires, the most spendthrift gamblers, the largest gold market, the largest diamond market, the busiest port, the most crowded skies, the most exciting skyscrapers, the widest range of luxury shops, the most expensive apartments, the lowest taxes, the most efficient civil service and the least corrupt police force”. (Dimbleby: 1997)

Hong Kong has celebrated its 10th anniversary of the restoration of sovereignty. How has the economy been in the decade since then? Thai baht and Malaysian ringgit collapsed in 1997 due to the US dollar-peg policy, Hong Kong and other Asian countries suffered from the Asian contagion. The Asian Financial Crisis in 1997, the subsequent burst of economic bubble in 1998 and the unfortunate *Severe*

Acute Respiratory Syndrome (“SARS”) outbreak in 2003 caused Hong Kong a severe economic downturn in the past ten years. Whenever Hong Kong faces daunting challenges, the central government would help ensure the success and prosperity continue. For example, the help included the relaxation of the rules of permitting Hong Kong people doing business on the Mainland through the Closer Economic Partnership Arrangement (“CEPA”) before opening the market to the World Trade Organisation (“WTO”) members, relaxing the “*individual traveler scheme*” to mainlanders to stimulate Hong Kong’s tourist business, allowing mainlanders to trade Hong Kong shares on the Mainland through the Qualified Domestic Institutional Investor (“QDII”) etc. The stock market recovered and the Hang Seng Index reached its historical high of 23,000 points in the second week of the 10th anniversary of the handover. The fiscal reserve restored from the bottom of HK\$296 billion in 2005 to HK\$310 billion in 2006. All in all, the economy went down to its bottom after the handover and seems to have been recovered in its 10th anniversary. However, the Mainland’s assistance also meant an increase of China’s intervention in Hong Kong’s affairs, diminishing Deng’s “*One Country, two Systems*”.

Based on its report for the second successive financial deficit and projected continuing deficits in the following fiscal years in March 2000, the HKSAR Government established a *Task Force on Review of Public Finances* (“*The Task Force*”) and an *Advisory Committee on New Broad-based Taxes* (“*The Advisory Committee*”). The former was tasked to identify whether the operating deficits were cyclical or structural in nature, while the latter was tasked to consider the suitability of new types of broad-based taxes for introduction in Hong Kong. Despite the fact that the fiscal reserve balance amounted to HK\$444 billion in the fiscal year 1999/2000 and the deficits were caused by the global recession and economic cycle, the Government tended to broaden the tax base.

In July 2006, based on the reports of the *Task Force* and the *Advisory Committee* released in 2002, the HKSAR Government invited responses to a consultation paper “*Broadening the Tax Base, Ensuring our future Prosperity – What’s the Best Option for Hong Kong?*” (“*GST Consultation Paper*”). The consultation was initiated to run nine months from 1 July 2006 to 31 March 2007 which was

uncommonly lengthy for government consultations. After the release of the consultation paper, the public responded negatively against the GST except that the Hong Kong Institute of Certified Public Accountants and the Hong Kong Institute of Taxation supported the GST, both organizations are regarded the representative bodies of tax professionals. It is worth noting that it was only tax practitioners expressly supported the GST. Most of the tax economists were on the frontline to oppose the GST. As a result, the public criticised the tax professionals who supported the GST because of their potential interest in the tax which might bring them more tax reporting business.

GST is a consumption tax, similar to Value Added Tax (“VAT”) in Europe, levied as a percentage added to the prices charged for most goods and services and on the value added in each stage of production. In essence, a GST is an alternative way of collecting a tax on consumptions and services. Adam Smith gave a good reason why the government levies a consumption tax, *“The impossibility of taxing the people, in proportion to their revenue, by any capitation, seems to have given occasion to the invention of taxes upon consumable commodities. The state not knowing how to tax, directly and proportionally, the revenue of its subjects, endeavours to tax it indirectly by taxing their expense, which, it is supposed, will in most cases be nearly in proportion to their revenue”* (Smith, 1776: 1102). Because of their similarity, the term “GST” and “VAT” are used inter-changeably in this project report for simplicity.

Among the reasons of objecting the GST, there are three broad lines of the objections: (i) the tax base is not narrow and the deficits are not structural, (ii) the GST is an unfair tax, and (iii) the Government would overspend after implementing the GST.

1.2 PROBLEM STATEMENT

The Government has its reasons to implement the GST and the public have their concerns in the introduction of the consumption tax. The problems are whether the Hong Kong economy needs a GST and whether accountants support the GST.

1.3 THE SIGNIFICANCE OF THE STUDY

The simple tax system and the low tax rate have been the key factors of the success of the Hong Kong economy. The implementation of a direct consumption tax may make the tax system complicated and would have a far reaching impact on the economy. The attitudes of accountants towards the GST may affect the public and the Government. Therefore, this project is important in a few aspects. Firstly, it analysed the economy of Hong Kong and its financial policies, so that it would give readers of the pros and cons of the financial policies and the importance of the changes. Secondly, it analysed the effects of a GST on the economy. Thirdly, it examined the views of accountants which may affect the view of the public and the Government on the GST.

The first targeted audience of this project is the Government officials who are in charge of the Consultation. They may take the results of the survey as references to the implementation of a GST. The second audience targeted is the public and accountants. It is hoped that the analysis of the economy and financial policies help them know more about whether a GST is needed for the economy and whether accountants support the GST. The representative bodies of tax practitioners and accountants are the third audience. There has not been a survey of the views of accountants on the GST before this study, except for the view of a few active members on their board and committees. After the release of the survey report, the HKICPA carried out a similar survey. The result is consistent with this study, i.e. accountants were opposed to the GST.

1.4 OUTLINES OF THE PROJECT

The first chapter of this project is an introduction. The remainder of this project is organised as follows. The next section describes the aim, objectives and literature review. Chapter 3 explores the research methodology. This is followed in Chapter 4 by project activities for an overview of the Hong Kong economy and analysis of the public finance system. Next, the survey of accountants towards the GST is reported in Chapter 5. The project closes with concluding remarks and recommendations in Chapter 6.

CHAPTER 2

AIM, OBJECTIVES AND LITERATURE REVIEW

2.1 ORIGINS OF THE PROJECT

After the Government released the GST Consultation Paper, there have been numerous debates, forums and opinion polls. It is interesting that almost all economists, academics, entrepreneurs and the general public expressed their views against the GST, except the representative bodies of accountants and tax practitioners. This largely aroused my interest in the topic. The study would be significant to society. I experienced the same debates in Canada when it implemented a GST in 1990, the year I just migrated there. I saw the problems that the tax created in society and its impacts on the economy. After the HKICPA and HKTI expressly supported the GST, divergence between the public and accountants was developed. However, from my causal discussion with fellow accountants, they expressed different views from the Institute, which was reluctant to carry out a survey on the view of accountants despite that accountants cried loud for a survey. Moreover, no similar surveys or studies on accountants' attitude towards a GST have been published in other countries where a GST exists, except that I carried out a similar survey in 2001 (Yeung, 2001). However, the survey in 2001 was carried out among CGA members in Hong Kong only. The population and the sample size were small. The result might not be representative for accountants at large in Hong Kong. Moreover, it took a descriptive approach rather than an analytical approach. It is worth studying the topic and conducting a survey on the tax again.

In addition to my personal experience in the implementation of the GST in Canada and a survey done in 2001, my interests in the topic and my expertise in taxation were the major force that drove me to carry out the project.

2.2 AIM, PURPOSES AND OBJECTIVES

Partly invited by the Legislative Council of the accountancy functional constituency, the Honourable Mandy Tam, and partly motivated by the differential views expressed by fellow accountants, I conducted this study and a survey on the GST with the goal of achieving the following aim, purpose and objectives:

The aim of the project is to provide policy makers a reference for analyzing the need of a GST in Hong Kong. The purpose of this study is two fold. Firstly, it analyses the fiscal system. Secondly, it examines the views of accountants towards the GST. Even though the government-appointed *Task Force* and *Advisory Committee* have reported on the public finance structure and the tax base, it is hoped that this study may provide a different angle of analysis to fellow accountants and the public on the economy, public finance structure and the tax base. This report is important because it may provide information not mentioned in the *Task Force and Advisory Committee's reports* to interested parties that may need it for analysis.

The objectives of this study are:

- (i) To overview the Hong Kong economy and the economic policies;
- (ii) To analyse the public finance system and the tax base
- (iii) To explore the effect of a GST on the economy; and
- (iv) To examine the view of accountants towards the GST.

The first three objectives address the claims of the HKSAR Government that (i) the Hong Kong economy is facing future challenges; (ii) the finance system has structural problems; (iii) the GST provides a solution to the financial policy. The fourth objective is to investigate the claim that accountants support the GST.

2.3 LITERATURE REVIEW

(a) Literature view on the economic transformation

There are two broad schools of thought on the factors attributed to the prosperity and economic success of Hong Kong. One is the “*Natural Resources School*” which refers to the geographical advantage and quality human resources that Hong Kong has. The other is the “*Institutional School*”, which stresses the free economic policies. Both schools of thought are not mutually exclusive (Schiffer, 2004: 201-216), all the factors raised by the schools contribute to the success of Hong Kong.

The “*Natural Resources School*” claims that the strength of Hong Kong is its geographic location, even though some economists regard Hong Kong as resource-poor since it has no natural resources such as oil or valuable minerals (Greenspan, 2007: 258). Hong Kong is located at the shore of South China, the centre of Asia with a beautiful coastline and magnificent harbour. Its great value to trade was found some 150 years ago. In 1845, Governor Davis found that one great advantage of Hong Kong was for storing goods for the Canton (or called “Guangdong”) market (Endacott: 1973: 74). Governor MacDonnell reported that the China trade of Hong Kong in 1984 had extended to all over Mainland China (CO129/44, Cited in Fok (2004), p.98). Before the Second World War, Hong Kong was a fishing port. Other than fishery, it was strong in trade but weak in industry. Owing to the Civil War between the Nationalists [also called KuoMingTang (“KMT”)] and the Communists after the Second World War and political changes, a huge amount of skilled labour, capital resources, energetic entrepreneurs and industrialists flowed to Hong Kong during the period from 1948 to 1951. This huge inflow of human and capital resources subsequently made Hong Kong transform from a fishing port into an entrepôt. Today, some sixty years later, the flow back of human and capital resources from Hong Kong to China contributes tremendously to China’s modernization (Sit, 1998: p.880 – 904).

The deterioration of the relationship between China and the West after the Civil War as well as the export embargo on the supplies of strategic commodities to China after the outbreak of the Korean War caused a structural change in Hong Kong’s economy. After 1951, Hong Kong was gradually transformed from a small entrepôt into a trading, manufacturing and today’s financial centre. The industrialization of the PRC in the 1960s was the first significant structural change of the Hong Kong economy. The manufacturing

industries in textiles, plastics, electronic and wigs accounted for more than 25% of GDP throughout the period 1961-76 [Source: *E.R. Chang, Report on the National Income Survey of Hong Kong; 1970s- Census and Statistics Department, Estimates of Gross Domestic Product (1979)*]. The second dramatic structural change was the emergence as an international financial centre, even though the fishing village at the south-west of Hong Kong Island “Aberdeen” (a name probably borrowed from the Scottish fishing Port “Aberdeen”) remains famous in seafood, reminding us that Hong Kong was a fishing port in the old days. The transformation can be seen in Table 1 (p.16).

In 1970, manufacturing contributed 30.8% of the net output of the economy and employed 47% of the work force (Source: estimate of Gross Domestic Product (1979) and Census Report 1971). By 2005, these proportions fell to 3.4% of net output and 6.4% of the work force respectively. On the contrary, the financial and commercial services arose from 14.5% of GDP in 1970 to 21.6% in 1972 and the level has been maintained since then. It reached as high as 24.9% in 1994 even though it fell to 21.9% in 2005 due to the economic downturn (Source: Census and Statistics Department, HKSAR up to revision date 28 February 2007). 14.1% of the total workforce was employed by the financial and commercial services sector in 2005 [Source: General Household Survey Section (2) Census and Statistics Department (2006 edition)].

Table 1: Percentage Share of Major Industries in Selective Years

Code	Economic Activity	1970	1972	1991	1994	1997	1998	2002	2005#
1	Agriculture	2.2	1.8	0.2	0.2	0.1	0.1	0.1	0.1
2	Mining and quarrying	0.2	0.1	0.0	0.0	0.0	0.0	0.0	0.0
3	Manufacturing	30.8	28.0	14.5	8.5	6.0	5.6	4.2	3.4
4	Utilities (electricity, gas and water)	1.9	1.7	2.3	2.4	2.4	2.9	3.2	3.0
5	Construction	32.9	4.1	5.2	4.6	5.5	5.7	4.2	2.9
6	Wholesale and retail trade	3.3	20.6	24.0	24.5	24.1	23.5	25.1	28.8
7	Transport and communication	21.9	5.7	9.0	9.1	8.6	8.7	9.9	10.1
8	Financial and commercial services	14.5	21.6	21.0	24.9	24.4	22.6	20.0	21.9
9	Community, social and personal services	17.2	15.8	14.4	15.2	17.0	19.0	21.5	19.2
	Others/Ownership of premises	0.6	0.6	9.5	10.5	11.7	11.9	11.8	1.7
	GDP at factor cost	100	100	100	100	100	100	100	100
Sources: 1970-1972 Census and Statistics Department, <i>Estimates of Gross Domestic Product (1979)</i> 1991-2005 Census and Statistics Department, <i>HKSAR up to revision date 28 February 2007</i> . #The figures in year 2005 are subject to the Department's later revision.									

(b) Literature review on financial policies

On the other side, the “*Institutional School*” claims that the *positive non-intervention policy*, *fiscal prudence policy* and *simple tax system* are the factors that lead to the success of Hong Kong. Friedman (1997b, 1998b) supported this and praised that Hong Kong exhibited a free economic model.

(i) Positive non-intervention policy

The *positive non-intervention policy* is rooted from Laissez Faire policy, under which, there has not been too much government intervention in industries and trades. The major utility companies are owned by private enterprises. There are no foreign exchange controls. Currencies can be moved freely in and out of Hong Kong. The government public expenditure was not more than 16% of the GDP before 1997. Even though it increased to more than 20% after the handover of sovereignty, it

has been controlled below 20% after 2004. The tax system is simple, under which the tax rate is moved in the range from 15% to 18% for both individual standard tax and corporate profits tax; and only 5 types of imported products are subject to excise tax. All these made Hong Kong become one of the four economic dragons in Asia.

The positive non-intervention policy was raised by John James Cowperthwaite (Financial Secretary during 1961 to 1971) in 1971 and is built on the philosophy of *laissez-faire*. It has been praised as a significant factor contributed in the rapid growth of the economy and the economic success of Hong Kong. Cowperthwaite is influenced by the theory of the classic economist, Adam Smith who advocates a free trade economy. Smith's masterpiece: "*An Inquiry into the Nature and Causes of the Wealth of Nations*" written 200 years ago, but most of his economic theories still live today and influence numerous economists. He holds the view that government regulations are normally influenced by those who stand to benefit from them but they are not necessarily advantageous to the economy. He explains:

"The interest of the dealers ... in any particular branch of trade or manufactures, is always in some respects different from, and even opposite to, that of the public. To widen the market and to narrow the competition, is always the interest of the dealers. To widen the market may frequently be agreeable enough to the interest of the public ; but narrow the competition must always be against it, and can serve only to enable the dealers, by raising their profits above what they naturally would be, to levy, for their own benefit, and absurd tax upon the rest of their fellow-citizens. The proposal of any new law or regulation of commerce which comes from this order, ought always to be listened to with great precaution, and ought never to be adopted till after having been long and carefully examined, not only with the most scrupulous, but with them most suspicious attention. It comes from an order of men whose interest is never exactly the same with that of the public, who gave generally an interest to deceive and even to oppress the public, and who accordingly have, upon many occasions, both deceived and oppressed it" (Smith, 1776: 267)

According to Adam Smith, the market mechanism is governed by the invisible hand. The duties of the government should be confined to (i) to protect society from the violence and invasion of other independent societies, i.e. national defence; (ii) to establish a system of justice that a legal system to define and protect every citizen's rights; (iii) to establish certain public works and institutions. Even though not all his economic theories are agreed by economists, his view on

the role of government is generally supported by free economists. Friedman concluded the role of government in a view closer to a modern world

“A government which maintained law and order, defined property rights, served as a means whereby we could modify property rights and other rules of the economic game, adjudicated disputes about the interpretation of the rules, enforced “contracts, promoted competition, provided a monetary framework, engaged in activities to counter technical monopolies and to overcome neighborhood effects widely regarded as sufficiently important to justify government intervention, and which supplemented private charity and the private family in protecting the irresponsible, whether madman or child – such a government would clearly have important functions to perform. The consistent liberal is not an anarchist”. (Friedman, 2002:34)

Both Smith and Friedman concurred that the basic role of government is to provide public goods and service as well as to maintain the rules and regulations of society, even though it may have changed in the passage of time.

Back to positive non-intervention policy, Phillip Haddon-Cave (Financial Secretary 1971-1981), the successor of Cowperthwaite, explained it as:

“this (positive non-intervention) involves taking the view that, in the great majority of circumstances it is futile and damaging to the growth rate of the economy for attempts to be made to plan the allocation of resources available to the private sector and to frustrate the operation of market forces.” (Lethbridge, 1980: xii)

He further set out the objectives of fiscal policy in his 1977/78 Budget Speech on 2 March 1977:

“first, progressively, and to the maximum extent that the economy will permit, to implement approved Government policies and programmes in such a way as to secure the public interest; secondly, to ensure that revenue is raised as equitably as possible as between particular classes and groups of taxpayers or potential taxpayers; thirdly, to minimise any adverse effects of public expenditure and of the fiscal system on the internal cost/price structure of the economy and private investment decisions so that the growth rate of the gross domestic product is not constrained or business confidence damaged”.

The policy advocates a laissez-faire economy on the one hand and keeps the size of government small on the other hand. To a certain extent, the positive non-intervention policy provided the Government with a convenient excuse to turn

down the increasing public demands and thus reduced the level of intervention. Owing to the adoption of laissez-faire capitalism, Hong Kong has been ranked by the Heritage Foundation (*established in 1973, the most broadly supported public research Institute in the U.S.A. <http://www.heritage.org>*) and the Fraser Institute (*established in 1974, is a US and Canadian based international research and education institute*) as the world's freest economy in the past 12 years.

(ii) Fiscal Prudence Policy

Apart from exercising laissez faire capitalism, Phillip Haddon Cave, also set out some guidelines to achieve the fiscal policy, which are in principle a prudent balanced budget approach. He explained in a speech, “*we seek to achieve a balance between revenue and expenditure allowing surpluses to accrue when the economy is growing fast and revenue flushing and not eliminating deficits that arise from a temporary slowing down of the economy*”. It is clear that his proposed balanced-budget approach is on a pronounced economic cycle rather than on an annual basis. A short term deficit arisen from economic cycle should not be a serious issue to be dealt with.

(1) Government Revenue

What are the sources of public revenue? Government revenue comes from two sources: (i) the revenue of people and (ii) property belonging to the “sovereign” (Smith, 1776: 445). The former is taxes and charges while the latter is the natural resources that a nation possesses. Hong Kong has no exception. The Government gets all of its revenue from these two sources even though Hong Kong has limited natural resources.

Taxation is needed to finance public spending, which aims at meeting fundamental economic and social objectives. However, if a government takes all of its people’s income, they are likely to stop working or, more likely, to hide most of their income. Therefore, when funds are raised by ways of taxes to finance the government spending, the most important thing to consider is how they work and how people price the government. If people find the tax is too high or unfair, the underground economy will grow. Thus, before a new tax is imposed, the costs and benefits of the tax must be analysed. The public perception of the fairness of a tax, the practical enforceability of tax rules and the cost arising from compliance are also important factors to consider.

(2) Government Spending

How are the government revenues spent? The government expenditures go for a great many things. Adam Smith stated that “*not only expenses of defending the society ..., but all the other necessary expenses of government, for which the constitution of the state*” (Smith, 1776: 445). Defence expense has not been a big burden in Hong Kong since it was provided by the British government before 1997 and the Chinese government is responsible for it after the sovereignty handover.

Economists measure the size of government in term of government spending, either to revenue or to GDP. Some refer the size of government as the amount of redistribution of revenue (Becker & Mulligan, 2003: 314). Economists support redistribution measurement because some government spending is not

redistributive (e.g. tax expenditure) and, some GDP fluctuations are unrelated to government spending. In this project, the ratio of government spending to GDP is used to measure the government size because it is widely used in literatures. This measurement gives better comparability and the data is easier to access. The larger the ratio of government spending to GDP is, the size of government is said to be larger, and vice versa.

The view of whether government expansion helps or hinders economic growth is so divided. Advocates of bigger government size claim the government spending can boost economic growth by increasing employment opportunity. Hobbes (1651) stated that government was an essential component of civilised life. It has to protect its citizens and their property, maintain orders of society, resolve disputes and keep other functions well in order that keep the economy growing. It is undeniable that economic growth can be enhanced through efficient provision of sound infrastructure and public goods, which are generally defined as those goods that the public needs but could not be functioned well through market mechanism alone, e.g. national defence and water supplies. However, it depends on how much cost would be used to achieve the growth.

Smith (1776) was opposed to extensive government action because he believed government action would usually make matters worse. He said:

“Great nations are never impoverished by private, though they sometimes are by public prodigality and misconduct” (Smith, 1776: 342); and

“It is the highest impertinence and presumption... in kings and ministers, to pretend to watch over the economy of private people, and to restrain their expense ... They are themselves always, and without any exception, the greatest spendthrifts in the society. Let them look well after their own expense, and they may safely trust private people with theirs. If their own extravagance does not ruin the state, that of their subjects never will.” (Smith, 1776: 346).

Coase supports Smith’s view and expressed,

“... the continued expansion of the government’s role will inevitably lead us to a situation in which most government activities result in more harm than good”. (Coase, 1994: 63)

Amongst all, Milton Friedman is the foremost advocate of “small size government”, he said,

“What was important was cutting government spending, however spending was financed. A so-called deficit is a disguised and hidden form of taxation, and so a bad form of taxation. The real burden on the public is what government spends (and mandates others to spend), not that part of its spending that is financed by open taxes.” (Friedman, 1998a: 354).

Gwarthney et al states this clearly, “There is overwhelming evidence that both the size of government and its expansion have exerted a negative impact on economic growth during the last several decades. All evidence points in the same direction: Larger government means slower economic growth....The core functions of government are vitally important. Government serve their citizens well when they protect property rights and enforce contracts, provide a stable (and freely convertible) currency, promote freedom of exchange in both domestic and international markets and rely primarily on competitive markets to allocate goods, services, and resources. However, as they move beyond these core functions, the tax and spending policies of governments soon become counterproductive and they begin to restrain economic growth and cause income levels to fall well below their potential. This is precisely what has happened in the US and other Organisation for Economic Cooperation Development (“OECD”) countries in recent decades.” (Gwarthney et al, 1998: 27)

Supporters of small size government generally hold the view that increasing government expenditure undermines economic growth by taking resources in term of taxation or whatever means from the private sector of the economy to government, which makes the resources less productive. Friedman makes this clear:

“if additional spending is financed either by taxes or by borrowing from the public... government has more to spend, the public has less. Higher government spending is matched by lower private spending for consumption and investment”(Friedman, 1980: 264).

Of course, there are some opponents to free economy. John Stuart Mill disagreed that the functions discharged by governments were essentially unproductive. However, his argument *“there was little to distinguish the protective works on a private property (such as the hedges and ditches of a farm) from those supplied by governments when they financed police officers and courts of justice” (Mill, 1844: 78)* is not too different from free economists who also support a minimum size of government to safeguard the laws and order of society. Among them all, the most extreme is the Marxist who stresses planned economy, i.e. a total government intervention. Keynesian advocates expansionary and contractionary fiscal policies which adjust the government spending or tax rates to stimulate demand. The

multiplier effects on additional demand for consumption by the increase in government spending or tax cuts make the economies grow (Keynes, (1935); Nelson (2006)). However, the major criticisms to the increase in government intervention are that it discourages private investment, which is the primary factor of increasing productivity, and leads to inflation because of the time lag between the implementation of the policy and the economic changes (Friedman, 2002: 76). Moreover, the budget deficits would be financed by borrowing or “printing money” (increase the money supply). However, the higher borrowing will push up the interest rate and discourage private investment. The crowding out effect would not only make the fiscal policy not as effective as expected, but also crowds out investment which results in declining the growth of productivity growth and real GDP. Consequently, larger government leads to less economic growth.

For public expenditure, some hold the view that it depends upon how they are financed and what governments spend on e.g. it may be justified for those so-called public goods, such as education and national defence. (Friedman 1998a: 354) disagreed with this that:

“The real burden on the public is what government spends (and mandates others to spend), not that part of its spending that is financed by open taxes. As I have said repeatedly, I would rather have government spent one trillion dollars with a deficit of a half a trillion than have government spend two trillion dollars with no deficit.” and

“inflation is always and everywhere a monetary phenomenon” and “my views on government spending can be summarised by the following parable: If you spend your own money on yourself, you are very concerned about how much is spent and how it is spent. If you spend your own money on someone else, you are still very much concerned about how much is spent, but somewhat less concerned about how it is spent. If you spend someone else’s money on yourself, you are not too concerned about how much is spent, but you are very concerned about how it is spent. However, if you spend someone else’s money on someone else, you are not very concerned about how much is spent, or how it is spent”.

Government expenditure includes transfers and subsidies that enlarge the size of government. The growth of government size will retard private investment and will require higher tax and/or new borrowing, both will reduce productive incentives in private sectors. Apart from the little effect on economic growth, transfers and subsidies also likely bring up more rent-seeking problems, i.e. it will

increase the incentive of various business and interested groups to seek the transfers and subsidies. Rent-seekers attempt to obtain direct government benefits rather than engaging in productive activity (Tullock, 2005: 175, 214-215).

In summary, free economists do not object to the view that the government has its functions in society and it has to spend to provide an infrastructure for the operation of a market economy and a limited set of public goods. Their concern is that as the government continues to grow, more resources will be allocated by political reason rather than market forces. The ultimate beneficial effects on economic growth will turn to negative owing to (i) higher taxes or borrowing required to finance the government spending; (ii) diminishing returns on its increasing activities; (iii) slowing wealth creation by its inherent bureaucratic system.

The experience of those centrally planned economies and free economies is a significant proof of the adverse impact of government size on economic growth (Vedder & Gallaway, 1998). The comparison of economies between the former Soviet Union and the USA; East Germany and West Germany; North Korea and South Korea, Communist China and the Colony of Hong Kong has provided significant evidence that when governments monopolised the allocation of resources and economic decisions, the rate of economic growth is lower. China's open economic policy in the 1980s, which abandoned its 100% government-owned economy, has improved its economic growth. The improvement of economic performance in Mainland China after its adoption of a more open economic policy suggests large government size would bar economic growth.

(iii) Literature review on the principles of taxation

Tax is also regarded the “price” of the public goods and services that the government supplies for its people's benefit. However, the “price” is whatever beyond the people's (consumers') control in a non-democratic system. Adam Smith (1776: 451-453) gave four general maxims to taxes, i.e. Equity, Certainty, Convenience of Payment and Economy in Collection. The maxims can be combined into two distinct principles for taxes: (i) Benefit Principle (ii) Ability-

to-Pay (Musgrave, 2005: 135-138). While “Benefit Principle” serves the functions of allocation of resources, the “Ability-to-Pay” principle in taxation serves the purposes of wealth redistribution and equality. If a new tax is raised or an existing tax system is changed, these two principles should always be the guidelines.

The benefit principle is based on the private market mechanism under which taxpayers pay for the public goods and services they receive like those that they purchase from the private market. Taxpayers price the benefits they receive from the public service provided with the government resources, thus it is also called benefit taxation. It works as in a private market where the price is determined by the demand and supply mechanism. Consumers (taxpayers) determine the fair level of price (tax) of the public goods and services. The level of tax determines the allocation of resources and so on. The demand of taxpayers for the goods and service gives a clear signal to the government about the amount of goods and services to produce. Taxpayers pay in proportion to the benefit received, but pay nothing if they receive none.

Most of the taxes or duties charged under the head of indirect tax are based on the principle of benefit taxation, e.g. tunnel tax, gasoline duties and sewage charge etc. However, some benefit cannot be measured from the public service provided, such as national defence and public education. The benefit of national defence can neither be allocated among taxpayers nor exclude those non-taxpayers from receiving it. In an analogy, public education benefits both the recipients and non-recipients.

When the public goods and services are so essential for society and cannot work well under benefit principle, the ability-to-pay principle applies. Under this principle, the higher tax burden will be borne by those who have better financial ability to pay. Economists particularly equate fairness of taxation to the ability-to-pay principle:

“Equality ought to be the rule in taxation as it ought to be in all affairs of government. Whatever sacrifice it requires should be made to bear as nearly as

possible with the same pressure upon all.” (Mill, 1921: 155)

Ability is generally measured by an individual’s income and accumulative wealth which are then taxed under income tax and wealth tax respectively. There remains an issue how the tax burden should be allocated among different levels of “abilities”: proportional, aggressive or regressive? Should taxpayers with twice the “abilities” pay double tax, less or more than double? The same issue may be easier to solve in the “benefit principle” than the “ability-to-pay” as the marginal diminishing return will reflect in the pricing strategy.

Equity in taxation itself is divided into two main dimensions: horizontal equity and vertical equity. Horizontal equity is concerned with taxpayers in like situations be treated alike, i.e. paying the same tax. Vertical equity addresses the issue of the relative taxes paid by people with different capacities to pay. Horizontal equity deals with the relative treatment of equals whereas vertical equity addresses the relative treatment among unequals (Musgrave, 2005: 135-138). The issues in vertical equity are whether the tax should be progressive, proportional or regressive and if people with greater capacity to pay, how much more it will be. A tax is considered *progressive* when the effective tax rate is higher for higher income groups. Conversely, the tax is considered *regressive*. A tax is considered *proportional* if the effective tax rate is the same across all income groups. GST is regressive in nature despite how it compensates the low income group. It violates both the ability-to-pay principle and the benefit principle as the majority of consumption, which it taxes, is private goods. Thus, GST is hardly a fair tax.

The Government claims that the GST is fair based on the assumption that higher and wealthier groups would spend more, so that they pay a higher amount of tax. However, taxes may not be levied on true taxing capacity as the Government says. Consider a sales tax on consumption goods. The same statutory rate applies to purchases no matter what the characteristics of the household making the purchase. Thus a sales tax would appear to be proportional. However, the basic income formula (see section (iv) below) indicates that the proportion of income spent on consumption goods declines with increasing income. A household with

a \$100,000 annual income will not spend twice as much on consumption goods as a household with a \$50,000 annual income. Thus, while the statutory tax rate appears proportional, the effective tax rate, defined as “*tax divided by income*” declines as income increases, making the GST regressive.

(iv) Goods and Services Tax

All governments like GST because it is broad-based and stable to generate revenue to keep the society running. They have been encouraged when New Zealand successfully implemented a comprehensive GST in October 1986. This new consumption tax was favourably received in New Zealand because it replaced a widely criticised single-stage wholesales tax on the one hand and exchanged a commitment to having the income tax system simplified in return for the introduction of the GST on the other hand. In addition to the significant reduction of the top marginal income tax rate, the transfers to lower-income group were increased to compensate the tax’s regressivity, which is the common argument against the consumption tax. However, the initial rate of 10% adopted in 1986 has been increased to 12.5% since 1989. Since then, Canada, Australia, Singapore, Malaysia and other countries that faced financial stress followed. There are about 140 countries that have implemented a GST. Some more countries will effect a GST soon. For instance, India is expected to introduce a GST in 2010. Apart from its broad based nature, the trend to implement a GST is the result of tax competition among countries. Gorter and Parikh (2000) found that for each percentage-point reduction in the marginal tax rate on capital relative to the European Union (“EU”) average tax rate, any given EU nation’s flow of foreign direct investment tends to increase by about 4 percent, i.e. lower income tax rate would increase the flow of foreign direct investments. Countries tend to reduce their income tax rates in order to induce foreign investments. By reducing their tax rates, countries need to broaden their tax bases sufficiently to generate revenue to compensate the loss in income tax. The phenomenon is common in European countries. Recently, Singapore announced a reduction to its income tax rate to 18% for the purpose of attracting more foreign investment. However, it has to raise the GST rate by 2% to generate tax revenue. Obviously, its target competitor is Hong Kong where the income tax rate is 16.5%. In order to reduce the harm of

tax competition among countries, thirty member states of the Organisation for Economic Cooperation Development (“OECD”) entered into a “*Memorandum of Understanding*” requiring member states to “blacklist” countries with “harmful tax regimes” which set their tax rates sufficiently low to “*unfairly erode the tax bases of other countries and distort the location of capital and services*”. After imposing a series of European Union (“EU”) Directives, EU member states have to implement a common VAT system even though some member states have negotiated VAT exemption or variable rates for regions or territories. With few exceptions, the standard rate of VAT for the member states is between 15% and 25%. However, when there is a common VAT system, reducing income tax rate will again become more effective to attract foreign investments. Investors are not only looking at places with low income tax rates, they will also look at places with more effective returns on their investments taking the operation costs into consideration. GST will increase the operation costs by pushing the general price up. Moreover, GST is not covered in tax treaties between countries. Therefore, some countries hesitate to introduce a GST, such as the USA where the supply-side economists have promoted to replace a GST for income tax in the U.S.A, but they have not had much success.

Consumption tax charged at the same rate to purchases appears to be proportional but is in fact regressive. It is because consumption would not increase at the same rate as income increases, making a consumption tax regressive. Moreover, whether tax on consumption is in proportion to revenue depends on the elasticity of consumption as well as the equality of distribution of income. People may not spend in proportion to their earning. High-income households generally save larger portions of their incomes and earn more untaxed income from interest and capital gains than low-income households. The following basic income formula clearly shows that people would not spend all their income as they would save or invest their unused income.

$$\text{Income (Y)} = \text{Investment (I)} + \text{Savings (S)} + \text{Consumption (C)}$$

Keeping income constant, GST would increase the consumption price, decrease investment or savings. The decrease in investment would lower the productivity

of the economy. Also, based on the demand and supply market mechanism, the price rises, demand decreases. The national income would fall in the end.

Most governments claim that GST reduces tax avoidance and evasion. The rationale of this is that in most countries, the invoice method is used in tax collection. Each registered business is liable for the tax levied on the basis of its sales, and it is supposed to pay GST on all the inputs that it purchases, which it can claim tax credit against the GST it collects from sales. As the tax credit is only allowed if the purchases are supported by invoices, the GST system provides a strong incentive for registered businesses to police themselves against tax avoidance and evasion. Purchasers will be liable for the tax for purchases without supporting invoices or the purchases become non-deductible in income tax. Thus, businesses are supposed to have a strong incentive to buy only from GST suppliers. Spiro (1993) points out that the argument of this “advantage” could not stand because businesses that have no intention to evade tax would already have demanded invoices from its suppliers for income tax documentation purpose. No strong evidence shows that the addition of a GST would increase the degree of reporting. Conversely, it gives consumers a higher incentive to pay cash to reduce the GST if a seller offers to sell free of GST. Moreover, a GST may increase tax avoidance if taxpayers have already been annoyed with high tax or find the tax unfair. As a result, the corresponding income tax will be lost. GST gives the “*cash economy*” or “*underground economy*” a bonus. Look at the examples in Mainland China, which uses VAT vouchers to control the deductibility of expenses. What happens in reality is that manufacturers sometimes have to purchase from non-VAT registered suppliers because of the scarcity of materials. As a result, the sales will be understated to “match” the purchases with supporting vouchers. Countries not only suffer the loss of revenue of the GST and income tax revenue, but the increase in cash economy is also unfair to honest taxpayers.

In 1991, Canada introduced a GST to replace the 13.5% Manufacturers’ Sales Tax (“MST”) which had been in effect since 1924. The GST was initially charged at the rate of 7% and reduced to 6% after 16 years in 2007. Shortly after the GST was introduced, the sharp rise in the use of cash attracted numerous researches and studies. Results of empirical research showed that GST increased the size of

underground economy where underground economy means activities with payment in cash and no tax reporting, i.e. the activities are legal, except the tax evasion (Pigeon, 2004).

Based on an analysis of the ratio of cash balances to consumer expenditures, Spiro (1993) carried out research on the size of the underground economy in Canada after it implemented a GST after 1990. He estimated the GST increased the size of the underground economy by as much as 8% of GDP between 1991 and 1992 and caused a loss of tax revenue of roughly Can\$2.3 billion in Canada in 1992. Statistics Canada criticised that his research ignored the possibility of people using more cash in other aspects. By a narrow definition of the underground economy, Statistic Canada estimated the value of the underground economy was about 1.4% to 5.2% of GDP. However, numerous subsequent studies employing different statistical techniques supported Spiro's contention that the GST contributed to growth in the underground economy. Giles & Tedds (2002) concluded that the underground economy in Canada was about 15% to 16%. A survey conducted by KPMG during the week 31 Jan to 5 Feb 1994 found that the political opposition to the GST and the visibility of the GST led to a perception of increased underground economy, even though it reported perceptions, not the actual level of evasion (Flexman 1997). In Australia, the Taxpayers' Research Foundation found that the underground economy had risen by about 1% of GDP in 2003 after a GST was introduced in July 2000 (Breusch, 2005). In the analysis of discrepancies in the GDP data, Gervais (1994: 60) and Smith (1994: 3-31) held the view that the underground economy began growing in Canada since the implementation of the GST. Spiro (1997) supported this view and found that the GST was the primary catalyst triggering the growth of the underground economy in Canada. Giles and Tedds (2002: 238) find strong evidence that if the GST had not been introduced but had instead affected a revenue-neutral increase in the effective personal income tax rate, then the underground economy would have been smaller. The increase in size of the underground economy was interpreted as a sign that taxpayers were angered by the GST.

The above findings supports that avoidance of the GST is not difficult and that the GST would increase the size of the underground economy.

CHAPTER 3

RESEARCH METHODOLOGY

3.1 RATIONALE OF THE RESEARCH DESIGN

This study adopted both qualitative and quantitative methods. Mainly documentary analysis and survey by questionnaires, including:

- (i) Documentary and literature review of the Hong Kong economy and examination of the public finance system;
- (ii) Literature review of the impact of a GST on the economy;
- (iii) A survey on the responses of accountants towards the GST.

3.2 USE OF LITERATURE

Literature was reviewed constantly throughout the project, starting with defining the scope of the project, exploring the deficiency of the literatures, analysis of the findings of the survey and ended with validating the conclusions. Most countries proposed to implement a GST when they were facing serious financial deficits for years, such as New Zealand, Canada and Australia. This project investigates the views of accountants towards the proposed GST. That is another means to investigate whether Hong Kong needs a GST in the perspective of accountants. Literature was reviewed to analyse the overall economy and financial policy with an aim to provide a foundation to analyse the need of a GST (1st objective). In order to narrow down the scope from analyzing all economic aspects, the public finance and the tax base (2nd objective) were focused on. After all these backgrounds and fundamental studies had been analysed, the project turned to the studies of the effect of GST on the economy (3rd objective). To address these objectives, both primary and secondary sources in documentary evidence were evaluated and analysed. Bell (1999: 108) defines “*primary sources are those which came into existence in the period under research. Secondary sources are interpretations of events of that period based on primary sources*”. In this project,

primary sources were used to analyse the financial position of the economy such as the government statistics, financial reports, budgets, officials' speech etc. These primary documentary sources provided evidence of the performance of the economy in term of Gross Domestic Products, Gini Co-efficiency, budgetary surpluses and deficits. Studies of the effect of a GST on the underground economy and the size of government were analysed. Primary sources have realism and authenticity, but have a narrow time frame and location (Neuman, 2004: 305). This project also utilised secondary sources such as books and articles which provided interpretation of the primary sources. These secondary sources provided the background and analysis of the financial policies of Hong Kong.

When primary and secondary sources were evaluated, only those considered authoritative and reliable, such as studies of renowned economists, were selected. To balance the views and maintain objectivity, theories and views were selected from different schools of thoughts, like classic, Keynesian and free economists. Some of the economic literatures are conflicting themselves. The classic economists, free economists and the social economists have their own views on the economy and their economic theories are supported by different empirical results. The differences may have arisen from the differences in times, environments, cultures, human behaviours or even the application of data. All their theories have certain degree of application to our economy. For example, both Keynesian and free economists can find some support to their theories in our fast growing economy. Their theses, theories, views and purposes were briefly reviewed. However, I did not choose any particular economic paradigm as this project was to analyse the economic policy adopted in Hong Kong and its performance in the economy. Moreover, the economic paradigm of the world had shifted from planned economy to free economy after the collapse of the cold war structure. Hong Kong adopted a mixture of Keynesian and free economic policy. For example, Milton Friedman appraised the free economic policy of Hong Kong, but in fact there were some extents of government interventions that he might not see such as the housing and public utility policies. After the Consultation Paper was released, there were a number of comments from economists, accountants, financial analysts, politicians, media etc. The common criticism against qualitative research is that conclusions are drawn from small and unrepresentative

samples (Grix, 2004:121), this report covers as many sources as possible. However, this report also avoids taking unrepresentative samples i.e. excluding comments from unauthoritative sources (such as information without giving credentials or from web page without validation) or personal opinion without taking sufficient analysis. Documents and articles, released by politicians, think-tanks, associations (like the HKICPA and media) were analysed their origins, purpose, political ideology and audience before referencing to and relying on them.

3.3 MEHTODOLOGICAL DISCUSSION

The cost of survey by questionnaires is low. The mail-out survey is convenient to carry out (Neuman, 2004: 180) and is affordable as the project has no financial support other than my own resources. It is an optimal option in a limited budget research, especially when the questions are straight forward (Palys, 1997: 147). It is manageable within my own resources. However, the disadvantage of this method is that people do not always complete and return questionnaires. The response rate is generally low unless the target population has a strong interest and is knowledgeable in the topic (Neuman, 2004: 181; Burnham et al, 2004: 96). When I decided to use this method, I expected accountants would have a strong interest and knowledge in the GST. Unfortunately, the restriction on the distribution of the questionnaires by the HKICPA rendered the response rate low because the HKICPA only sent 10,000 questionnaires to its member accountants out of a total of more than 25,000 members. As a result, not all member accountants were on the mailing list.

Apart from the mail-out questionnaires, I had considered interviewing methods: telephone, face-to-face and group interviews. Interviewing methods may obtain better response rate than mail-out questionnaires. Its adaptability would provide more in-depth information through follow up ideas, probe responses, investigate motives and feelings (Bell, 1999:135). It is easier to code the response for open-ended questions in interviewing method as it has “*chances to clarify ambiguities or misunderstandings and to monitor the conditions of completion*” (Palys, 1997: 146). Moreover, using more than one method or source of data is consistent with

the principle of triangulation (Bryman, 2001: 274). However, other than the concern of higher cost and more time involved, there are two major concerns with interview situations: first, the issue of interview effects and, second, the issue of interviewer fraud (Burnham et al, 2004: 101). Face-to-face or group interviews may benefit from the chance to clarify ambiguities through their interactive nature, but they may generate “*reactive bias*” since interviewees may be affected by the interviewers. For instance, interviewees may expect that the researchers are experts and tend to be very attentive to cues that the interviewer emits (Palys, 1997: 155). This may affect the results of the research with the unintentional response of the interviewees and the interviewers. Conversely, interviewer frauds may be done by the interviewers intentionally, such as the interviewer may complete the questionnaires himself due to limited time of interviews (Burnham, 2004: 102). Distortion may occur. These impacts could be solved by interviews to be conducted by well-trained interviewers or by myself. However, it was costly and time consuming to train up interviewers that was the restriction of this project. If interviews were conducted by me alone, the number of interviews could not be large enough to be a representative sample.

3.4 SURVEY BY QUESTIONNAIRE

To investigate the views of accountants towards the GST, a survey by questionnaire covering all accountants living in Hong Kong was conducted. All accountants were eligible to participate in the survey and to respond to the questionnaire once, i.e. each had an equal chance to respond. The advantages and disadvantages of various methods had been considered. Direct contact with participants through time study and face-to-face interviews is generally considered to produce more reliable data as any ambiguities or queries between the researcher and any respondent can be reconciled immediately “on-the-spot”, but such interviews could be time consuming and expensive to administer and, only a very small sample of accountants could be taken. Generally, the most commonly used and widely accepted technique is the mail out questionnaire survey, as it enables a large number of participants to be surveyed at a reasonable cost. Any unreliable or odd responses may be easily eliminated. These may arise from deliberate exaggeration (maybe due to an antipathy towards the government

or the tax), misinterpretation of the question or respondents interpreting the question differently.

In respect to the survey on the accountants' view on the GST, group discussions with multi-disciplinary professionals had been organised in a preliminary study to gain an insight into the GST proposal in the Consultation Paper. The discussions formed a preliminary scope of the survey, which became the framework of the questionnaires. The GST is a topic that the politicians, financial and economic professionals concern the most. Thus, views of the multi-disciplinary group, including legislators, tax advisors, academics, financial consultants etc. were taken into accounts when drafting the questionnaires of the GST survey. Besides the Legislative Councilor of the Accountancy Constituency, two accountants and a financial advisor formed a discussion group to set out the preliminary questionnaire with 9 questions, which took reference to the questionnaire on a GST that I did in another survey in year 2002. To minimise the common problems of unclear and ambiguous questions in questionnaires, a pilot test had been conducted to detect the weaknesses in the design of the questionnaire instrument as well as the difficulties in the analysis of data. A questionnaire of 9 questions was sent to a small sample of 20 accountants and non-accountants whom I knew. After the pilot test, I added 4 more questions about Hong Kong tax system. The additional questions served the purposes of, (i) testifying if the respondents found the tax system was narrow as the Government claimed; (ii) helping the respondents to think the tax system over before answering the question of the GST. Besides the additional questions, minor corrections to the questions were made and the format of the questionnaire was changed to reduce the number of pages so that it looked handy to respond. Some responses of the pilot test indicated that some types of tax were not easy to distinguish, for example, some respondents could not distinguish the difference between a GST and a sales tax. Some ambiguities in the questions were amended to avoid misinterpretation of the responses. The survey was designed mainly as a quantitative approach but also built in an open-ended question for the participants to express their views. It is a mix of quantitative and qualitative approaches.

The first and the most difficult issue was how to distribute the questionnaires to

all Hong Kong accountants. All their records are kept and controlled by the HKICPA. It is openly known that the relationship between the Legislative Councilor of the Accountancy Constituency and the HKICPA has never been in good term. It is generally believed that it is caused by the current post holder's marginal winning of 37 votes over the former president of the HKICPA in the last Legislative Council election (2004). Because of the different political stance between the two representatives and the Consultation Paper tool most of the HKICPA's proposal, the Institute was reluctant to distribute Ms. Tam's correspondences and the questionnaires to her electorates. Without the cooperation of the Institute, the traditional method of distributing the questionnaires by mail was almost impossible as the mailing addresses were held by the Institute and were not available for the "survey". The Institute only agreed to distribute the questionnaires to its members through its mass web-mail. The notice of the survey was put in an unnoticeable size at the corner of the mass web-mail to its members. Under these circumstances, a low response rate was not unexpected. The report was announced to the public through a press conference and radio forum.

In order to compensate for the weakness in distributing the questionnaires and increase the response rate, the questionnaires were also sent to internationally qualified accountants, who were residents in Hong Kong and possessed other reputable international accounting designations, through their Hong Kong branch. The common dual membership of accountants (membership of their home accounting association and the HKICPA) had the advantages and disadvantages. The advantage was that if they did not notice the survey on the HKICPA's web-mail, they might be notified by their home association. For those who possessed other accounting qualifications but were not members of the HKICPA, they could also participate in the survey. However, the disadvantage of this method was the possibility that the responses might be duplicated. This required detailed and careful analysis of the responses. If the analysis was poorly done, the result would open criticism and suspicion. A screening question was used at the beginning of the survey to make sure accountants from different associations could be included only once. The questionnaire requested that the respondents stated their membership and membership number for identification. Open-ended questions

were designed and scrutinised for similar purposes and to ensure quality responses. Any potential duplicated responses from one person were eliminated. This relied heavily on my auditing experience when reading people's responses. For example, the respondents' handwriting, use of words in open-ended questions etc. would give me hints whether there were likely duplicated responses. These are the techniques that auditors may use in the inspection of the validity of documents. Even though there is no guarantee that the responses are free from duplication, it at least reduces the possibility. After all, the respondents are professional accountants who have their own professional ethics to observe. The survey report section will deal with this issue in further details in Chapter 6.

The questionnaire contained 13 questions (see the questions in Appendix 2). Two questions (Questions 1 and 2) were designed to obtain the backgrounds of the participants, i.e. different groups of accountants (i.e. practising, non-practising and unemployed/retired) and whether they had lived in a country with GST or VAT. Ten questions focused on two major areas (i) the HKSAR's tax system (questions 3 to 7) and the GST (questions 8 to 12). The last question (Question 13) was an open-ended one giving respondents room to express their views on the tax system, the GST or other related areas. As mentioned above, to avoid double counting of responses, respondents were requested to provide the name of the institute they belonged to and their membership number. All responses were carefully checked and scanned to avoid double counting. The respondents were assured that their identity would be kept confidential, the information would not be used for other purposes and the results would be released in the form of aggregate statistics only (Appendix I).

3.5 TRIANGULATION

The advantage of using different research approaches to examine the same research problem is to avoid "*the problems associated with single-method, single-investigator, single-data, single-theory study*" (Burnham, et al, 2004: 277). Burgess (1982: 166) states that multiple strategies can prove costly in terms of time and money. Burgess (1982: 163) points out that "triangulation is not confined to data triangulation (multiple sets of data) or theoretical triangulation (multiple

theories), but also encompass multiple investigators working in partnership across disciplines.”(Burnham, 2004: 277). Other formal data collection methods were not used in this project but the results of this project can be compared with the survey conducted by me in 2001 (Yeung, 2001) and the survey conducted by the HKICPA shortly after this project. The HKICPA conducted a survey on the GST and found that 59% of around 2,000 respondents were against the GST. The results of these two surveys were consistent with the findings of this project.

In “A survey on Broad-based taxes for Hong Kong” conducted by me in 2001, 76 valid responses were received in a population of 800 CGA members consisted of approximately 10% response rate. In asking to list the order of preference of six “broad-based taxes”, sales tax and GST were the 5th and 6th least preferred tax respectively. Progressive profits tax and capital gains tax were listed the 1st and 2nd most preferred tax respectively. The results of the survey are consistent with the survey of this project.

The HKICPA carried a poll in November and December 2009 with 1980 (7.6%) accountants responded. Even though the HKICPA presented their results in a way that accountants preferred a GST to other broad based tax, the poll result showed 59% of responding accountants were opposed to the GST. This is consistent with the finding of this project. Both the results of my previous survey or the HKICPA’s poll support that accountants are opposed to a GST.

3.6 WORKER-RESEARCHER ISSUES

As indicated, I am a practising accountant and have been on the Board of Canadian Certified General Accountants Association of Hong Kong Branch for a number of years. I had many opportunities to collect “data” through the discussion of the topic with my clients and fellow accountants during our daily contacts at the workplace and at some functions organised by accounting bodies. Some accountants might not respond by returning the questionnaires but were quite willing to express their view in casual talks. Through these “informal interviews”, I learnt their views. Though I did not include them in my report empirically, their views were considered and helped me formulate the questions in some way. I

learnt their reasons of objection or support of the GST, which helped explain the responses of the questionnaires.

My position as a board member and past president of an accounting body helped me to contact accountants, either our members or members of other associations.

However, like most of other worker-researchers, the “insider issue” may affect my objectivity in analysing the results. Most professional practitioners (people work with their knowledge like lawyers, accountants, architects, engineers and others) have preconceptions about issues. They used to give their “professional advice” to clients and look at things subjectively. However, I certainly understand that it is different in the role of a researcher and a knowledge worker. Researchers have to analyse the collected data with objectivity, but it is a big challenge to a dual role researcher. When I asked my clients or other fellow accountants their views on the GST, they would also ask my views for sharing too. In some way, my view might influence them and form a source of bias. This was one of the reasons that I did not use interviews to collect data. To minimise my subjective views on the GST, I formed a professional group to help draft the questionnaires and used a pilot test to eliminate the potential leading questions.

3.7 ETHICAL CONSIDERATIONS

Another major issue of worker-researcher is the ethics that how researchers deal with confidential and unauthorised data. I was no exception. There were two major ethical issues I had to deal with. First, it was the low response rate. All researchers would certainly like to receive more responses than less in surveys. However, the desire for high response rate should not compromise the ethical principles of a researcher. I might have some ways to increase the response rate especially when facing the restrictions in mailing the questionnaires, but they have not been considered because they were not ethical to me as a researcher and a professional. In respect to the database of local accountants, every HKICPA member has a members’ directory or has the right to obtain their contacts in the Institute’s website. The contacts are facilitating members to communicate with each other for professional matters, such as sending clearance letters to new

clients' previous auditors to clarify if any professional reason that the new auditors should be aware of their potential clients before the accepting the engagement. The members' information in the directory should not be used for other purpose without the consent of the HKICPA and the other members. Another way to obtain information of accountants is from the list of electors in the accountancy constituency, but it is illegal if they are used for purposes other than the election and after the election period. Certainly, the easiest way is to use the members' data of the Canadian Certified General Accountants Association ("CGA-HK") since I have been active in the accounting profession and on its board of directors for many years. I can either access the members' database or use the association's communication channel to distribute the questionnaires. However, it is more unethical than the other two ways mentioned above as I might abuse the fiduciary duty that members rest on me when they elected me as director. The temptation of using the database in hand was large when the initial request for sending the questionnaires to accountants was rejected. Nonetheless, like other ethical researchers, I valued ethics higher than the higher response rate. Low response rate might render the results less assured but violation of the ethics might render the result unreliable. Thus the questionnaires were only distributed with the pertinent organisations' consent and through the ways at their discretion even though it was not to my satisfaction. I did not put any pressure on the staff or my "friends" to distribute the questionnaire in a way that may violate their ethics.

Certainly, ethical considerations are not limited to the use of the databases, it is a significant matter related to the value of the research project. Researchers are making choices throughout the projects, either honoring or violating the ethical principles (Booth et al, 2003: 286). Throughout this project, all sources are properly accredited, all data and results are honestly reported; all views (support or object) are properly disclosed. Even though the response rate is low, readers are assured that duplicated responses were eliminated, the data was interpreted as objectively as possible and the results reported as they were found. All of these (keeping the respondents' identify confidential and reporting their view, if eligible, honestly) are the ethical principles that I have to observe throughout the project. All these are also critical for the validity and reliability of a research project.

All responses without giving membership number were discarded to maintain objectivity, except one respondent who attached an assurance that he would not respond twice. After considering that some people might have sensitive identity that they had some personal concern and the chance of duplicating his reply was low, I took his response into account. As there were no explicit and material suspicion of duplicating response, such as identical answers in the open-ended questions, and the validity of the membership format, the respondents' membership were not double checked with their respective association. All responses were properly kept and assigned a number upon receipt to avoid any missing copies. All returned questionnaires will be destroyed after this project is marked.

Another issue that had threatened my objectivity was political influence. As mentioned earlier, the then Legislative Councillor, Mandy Tam asked me to conduct the survey. She had a time frame to announce the result and inform her political party for their voting attitude towards the GST at the Legislative Council meeting. At the atmosphere of that time, it would be difficult for those democratic Legislative Councilors to support the GST due to the public's objection to the GST. Mandy represented accountants on the Legislative Council, and the authoritative accounting body expressed openly that it supported the GST. Both the Legislative Councillor of the Accountancy Functional Constituency and the board members of the accounting body were elected by accountants. They both represented accountants but in a different role and a different position. It is not a secret that the political stance of Mandy is different from the Institute. The former is on the public side while the latter is on the pro-Government camp. The politician certainly wanted to have the survey results to please the public. Even though she did not and could not affect my analysis, she gave me pressure on the time of completion. Throughout the process, she neither requested to look at the responses nor interfered my studies. Moreover, all the responses were kept in my office handled by myself and my trusted staff. The participants' responses and their membership number were not put together in my files of analysis to avoid computer fraud. Their data were seldom copied and saved into any unprotected flash drive to avoid losing in public place. I myself might also have been influenced by my own experience in the GST in Canada and by some casual

discussions with politicians. Complete objectivity is probably never possible (Burn et al, 2004), I had kept these influence at a minimum.

3.8 CONCLUSIONS

The research methods of this project were mainly survey, documentary and literature review. The documentary and literature review form the basis of the interpretation of the survey results. The core research method of this project was the survey which aimed to find the attitudes of accountants towards GST, but it could not be completed without the literature finding to substantiate the survey results. These might not be the best methods that I could use for finding the solutions of the research questions, but they are at least appropriate for this type of project, taking the costs and time constraint into account and the context of the project. Should more resources be available and barriers be removed, structural interviews should be conducted to get more qualitative data for further analysis.

CHAPTER 4

PROJECT ACTIVITIES

4.1 ECONOMIC ANALYSIS

In analysing the need for a GST, the economic performance for the past 60 years was analysed. The broadest measurement of an economy's performance is Gross Domestic Product ("GDP"). In the absence of other better alternatives, this project used it to measure the economic performance. However, it has limitation in using the figures to compare the post war period with today's economy because the figures in those days are neither available nor produced by the Hong Kong Government. Moreover, the Census and Statistics Department started to provide the figures and estimated the GDP by expenditure approach in the 1960s but has adopted income approach since 1970. Expenditure approach is to measure the total spending within the economy. Broadly speaking, it is the total value of private and government consumption, investment, net exports (exports less imports) and the net increase in inventories. Income approach is to measure, in broad sense, the total of the values of wages and salaries, net interest, profits (including dividends and retained earnings), rents and royalties, and depreciation. Only since 1973, the measurement has become stable after an adequate set of economic statistics in Hong Kong is available. Thus, in analyzing the economy of Hong Kong from the post war period till now, the government records and other data conducted by other researchers were employed when the government statistics were not available, especially in the earlier days.

4.2 THE SURVEY ACTIVITY

The questionnaires were intended to be distributed to all accountants by the HKICPA and other local branches of overseas accounting associations, including the Certified General Accountants of Canada ("CGA-Canada") and the Certified Practising Accountants of Australia ("CPA Australia"). I had no problems to get the other accounting bodies' cooperation through the Legislator's help and my

connections with them. However, there had been some difficulties in getting the HKICPA to distribute the questionnaires due to their pro-government stance. The HKICPA refused to deliver the questionnaires, claiming that the Institute is an apolitical organization. In the end, owing to the members' pressure, the HKICPA sent questionnaires to 10,000 of its members in August but only briefly notified the other 16,000 members of the survey through its e-Circular on 6 September. The other accounting associations helped distribute the questionnaires through their mass web-mail system. The advantage of including other resident qualified accountants was that they might express their experience on GST in other countries and their valuable views could be taken into account. There was a risk that the views of multi-designated accountants might be doubly counted. However, I regarded this risk as low since qualified accountants have their professional ethics to observe and are generally trustworthy. Moreover, I took cautious steps to check the responses, including the handwriting and the membership numbers. If any were suspected of replying in duplicate or more, I would discard the responses. Among the responses, 90.3% of the responses were received from HKICPA members while the others were from the members of other qualified accounting bodies. 57.4% responded by fax, 26.7% responded by email, while 15.9% responded by post. As of 30 November 2006, I received 327 responses, of which 17 respondents did not give their membership number or identify their membership. I therefore did not take their replies into analysis even though these responses were not likely to be duplicates of others. Thus, the double counting risk was low. Even though only 310 responses to the questions were counted, all comments received from the respondents to those open-ended questions were analysed and taken into account. The responses rate is 1.3% of the total population of accountants which cannot be said to be high but is considered acceptable for a survey of this kind on the following grounds:

First, the questionnaires were sent independently by the HKICPA to all its registered members (accountants) either by post or by a notice in an e-Circular. With the help of the local branch of some international accounting bodies, the questionnaires were also distributed through their e-Network. Second, all responses were numbered and carefully scanned to avoid duplication. Third, it was a comprehensive survey which required the respondents to spend some time

and exercise certain professional judgement to complete the questionnaire. Moreover, they might need more time to respond to the open-ended questions. The response rate for a comprehensive survey of this type is expected to be lower than for one with only a few close-ended questions.

Fourth, a random sample of this size lies in the range of 5% to 6% level of precision at 95% confidence level is generally acceptable in most social research. Statistically, the result of 62.8% of the accountants against the GST would give us 95% confidence that 56.8% to 68.8% (i.e. 6% level of precision) of accountants opposed the GST. The sample was selected randomly. There is no obvious source of bias, and the result is strong, i.e. 2:1 against GST. The result is consistent with that of the survey conducted by the HKICPA in a later stage with a larger sample size of 1980. The survey gave us an indication of the likely views of the whole population of accountants on this important issue.

Even though I am confident that the sample fairly represented the population view, I certainly would like to have had more responses to the survey to provide us with a better estimation of the views of the accounting population on this controversial tax. However, to a certain extent, the distribution of the questionnaires was beyond our control. The e-Circular was not too effective to alert accountants to the survey, due to the small size of the notice on one hand and people's attitudes towards electronic mail on the other. Nevertheless, I was still grateful for the help of the Institute and the other accounting associations. I believe the results of this survey should provide certain insights to the Institute and the public about the views of accountants.

CHAPTER 5

LITERATURE BASED FINDINGS AND DATA ANALYSIS

5.1 ECONOMIC PERFORMANCE

The financial year of Hong Kong adopts the British system that it runs from 1 April to 31 March of the following year. Thus, the financial year from 1 April 1946 to 31 March 1947 is referred as year 1946/47 and so on. The financial indexes from 1946/47 to 2005/06 were used to analyse the economic performance for the past 60 years. The government revenue increased about 3,013 times from HK\$82 million in the fiscal year 1946/47 to HK\$247 billion in the fiscal year 2005/06 at current price. For the same period, the expenditure increased 2,710 times from HK\$86 million to HK\$233 billion and GDP increased from about HK\$1,575 million to HK\$1,472 billion, i.e. 935 times. From the figures, it is not difficult to find that the government revenue and spending grew higher rate than GDP. The GDP per capita has also increased from HK\$2,353 in 1961 to HK\$214,710 in 2006.

The government expansion can be found from the increasing involvement in financing, housing, social welfare and education. In 1946/47, the public revenue and expenditure to GDP were 10.4% and 8.1% respectively. These two indicators for the role of the public sector arose to 17.5% and 17.8% for revenue and expenditure to GDP respectively in 2005/06. Even though these indicators grew rapidly, they were still relatively smaller than most developed countries. The recent abandoned “*positive non-intervention policy*” had played a significant role in keeping the government size small. Apart from the positive non-intervention policy, the colonial Government adopted a fiscal prudence budgetary approach, keeping the budget balanced. There were only deficits in 7 fiscal years from 1946/47 until 1996/97. In all other years, surpluses were recorded. In accordance with the Basic Law, this fiscal prudence regime is supposed to be retained by the Hong Kong SAR Government. Article 107 of the Basic Law provides that Hong Kong SAR should “*follow the principle of keeping expenditure within the limits of*

revenues in drawing up its budgets, and strive to achieve a fiscal balance, avoid deficits and keep the budget commensurate with the growth rate of its gross domestic product". However, there have been deficits in 5 fiscal years after the handover in 1997/98 i.e. 1998/99, 2000/01, 2001/02, 2002/03 and 2003/04 with deficits HK\$23.2 billion, HK\$7.8 billion, HK\$63.3 billion, HK\$61.7 billion, HK\$40.1 billion respectively, partly due to the unexpected Asian Financial Crisis and the burst of the bubble economy in 1998, the SARS outbreak in 2003, and partly due to the increasing government intervention after the handover. Even though the economy was said to be recovered and uprising, the Census and Statistics Department announced that the Gini Coefficient, which is widely used to measure income disparity, rose from 0.518 in 1996 to 0.533 in 2006 (Source: Census and Statistics Department 2007), a historical high in Hong Kong. This indicates the economy was not truly restored, but instead an economic and social bubble might be embedded. To introduce a new tax of regressive nature, which is charged at a lower ratio to high level income taxpayers, might further widen the income and wealth gap (Kiefer, 2005: 304-P.305). This is supported by a recent study which found that the introduction of the GST in Hong Kong would have negative effects on the economy and widen the existing income disparity between the rich and the poor (Lam, 2007).

While the economic transformation brought us prosperity, there are disadvantages of being a financial centre. It results in greater exposure of the domestic currency to external pressures. Firstly, the US dollar-pegged, coupled with the external-oriented economy, complicates the fiscal and monetary policy. This is one of the main reasons that the financial system was struck in the Asian Financial Crisis in 1997 (Greenspan, 2007). Secondly, the statutory regulations have not grown at the same pace as the financial sector. The regulatory framework is needed to be stringent enough to eliminate irregularities and flexible enough to permit the expansion of legitimate activities. It is not an easy task to strike the balance.

Table 2 shows the surplus/deficit of the fiscal years after 1997/98, the relevant economic factors attributed to the deficits, and unemployment rates:

Table 2: Deficits and the relevant economic factors and the unemployment rate

Fiscal year	Surplus/(Deficits) (HK\$ million)	Remarks	Unemployment rate*
1997/98	86,866	A land fund was transferred to the revenue	2.4%
1998/99	(23,241)	Asian Financial Crisis/burst of bubble economy	5.5%
1999/2000	9,952		6.1
2000/01	(7,833)	Not yet recovered from the burst of bubble economy and provision for fall of market value of Ex fund Investment.	4.7%
2001/02	(63,330)	Not yet recovered from the burst of bubble economy	5.7%
2002/03	(61,688)	SARS outbreak	7.4%
2003/04	(40,128)	SARS outbreak	7.9%
2004/05	21,356		6.5%
2005/06	13,964		5.4%
2006/07	55,000		4.6%
<p>*Source: Census and Statistics Department (<i>Extracted</i>) The normal unemployment rate is between 1.0 to 2.0% which can be regarded as full employment in the Hong Kong economy.</p>			

From Table 2, we can see that 1997/98 had an employment rate far better than all the other years, which were suffered from high unemployment. The Chief Secretary, Henry Tang once said, at the time when he was Financial Secretary, that the employment rate could never be restored to the 1997/98 level during his lifetime. After the Asian Financial Crisis, the burst of the bubble economy and the SARS outbreak, people's income fell; and the size of government expanded. In his 2002/03 budget speech, the former Financial Secretary, Antony Leung, claimed that the causes of the fiscal deficit were (i) cyclical economic adjustment; (ii) economic restructuring; (iii) population ageing; and (iv) evolution of government policies. The cycling economic adjustments mainly reflect the consolidation of the property market and the burst of the bubble economy. The housing policy after 1997, which targeted to increase at least 85,000 flats a year. The intervention distorted the demand and supply market mechanism of the property market. As a

result, the reduction of real estate activities caused substantial reduction of government revenue. The fast growing economy in South China caused Hong Kong's economic activities shifted to Mainland China and economic restructuring. Coupled with the territorial tax system, the adverse economic factors have a profound impact on the government revenue. While the ageing population increased the demand for social welfare and health care, the slowing down of the economy increased the demand for alleviating poverty. Apart from the rising demand in these social welfares grounded on ageing population and economic issues, the education and housing policies as well as the rigid pay mechanism for government expenditure increased pressure on controlling government spending. All lead to a significant increase in government expenditure.

5.2 FINANCIAL POLICIES

Apart from the geographical advantages, inflow of human and capital resources in the 1950s, the financial policies have played a significant role in Hong Kong's economy. The major financial policies adopted were positive non-interventionism, fiscal prudence and a simple tax system.

(a) Positive non-intervention policy

In September 2006 the Chief Executive Donald Tsang announced the end of the *"positive non-interventionism"* policy. Even though Mr. Tsang later explained that his government would retain the *"small government, big market"* policy, and insisted that he only wanted the government to act *"when there are obvious imperfections in the operation of the market mechanism"*. Milton Friedman (2006) criticised that Mr. Tsang *"ignores the reality that if there are any 'obvious imperfections' the market will eliminate them long before Mr. Tsang gets around to it. Much more important are the 'imperfections' - obvious and not so obvious- that will be introduced by overactive government"*. The Chief Executive's announcement of the death of this free economic model, not only attracted criticism from Friedman, but also aroused Hong Kong people's concern of the effect of government spending and intervention on the economy as they had suffered from the economic downturn after 1997 which was largely caused by the

increase of government intervention in the economy.

After he was criticised for his public announcement of abandoning the “*positive non-intervention policy*”, the Chief Executive of the HKSAR Government Donald Tsang gave a good account in an article on how the financial secretaries, from John Bremridge (Financial Secretary during 1981-86) to Antony Leung (2001-03), interpreted the positive non-intervention policy and defended his abandonment of the long established policy. In general, all the financial secretaries had been committed to minimizing the government intervention and supporting the free market economy, including Mr. Donald Tsang himself when he was the Financial Secretary from 1995 to 2001.

To what extent the positive non-intervention policy has been implemented in our economy? Hong Kong has no central banking system. It does not have any kind of foreign trade restrictions and foreign control. However, the Government has exercised an expansionary policy in a slowing down economy and contractionary policy in an overheated economy for the purpose of stabilising the economy. Strictly speaking, economic intervention takes various forms in Hong Kong. Some forms are in a lesser degree of controlling, such as price regulation and profit undertakings in public utilities as well as public-financed promotional bodies, etc. These are generally acknowledged as taken in conformity to market operation. The Government does not influence the factor prices directly, like minimum wages and capital prices. However, some argue that the Government has actually deviated from *lassiez-faire* policy in the massive public housing, medical treatment, and land price (Asian Sentinel, 2006). For public housing, the Government provides subsidized low rent properties and low price flats in the Home Ownership Scheme. For the medical treatment, the recent service improvement in the long history subsidized medical system has already distorted the private hospitalization market. The Government has been criticised the most is its intervention in land price, which is the major factor cost of production. Hong Kong has never had a free market in land. All land in Hong Kong is leasehold land and belongs to the Government. Owing to the fact that only Hong Kong Island and Kowloon Peninsula were granted to Britain in the nineteenth century by China, the majority of the land was held on a lease which expired on 30 June

1997 especially the land in the New Territories. Under the Sino-British Joint Declaration and the Basic Law of the Hong Kong SAR, leases are extended to year 2047. The Government controls the supply of land to stabilise the market. When the demand for land is low, the Government reduces the supply of land. Conversely, when the demand for land is high, it increases the supply of land. On one hand, the Government controls the land supply to stabilise property price; on the other hand, it also designates certain tracts of land below market price for specific purposes which in its opinion are beneficial to the Hong Kong economy, such as the land granted for capital-intensive industries by way of private treaties in Tai Po and Tsing Yi Island in the 1970s; and the land granted for public transport or container port for strengthening the infrastructure. However, the artificially induced land scarcity under the sales limit of "50-hectare per annum" of land plot under the Sino-British Joint Declaration and the later land sales application system after the restoration of the sovereignty pushed up property prices. The high land price increases the costs of living and decreases our competitiveness. Perhaps, the high property value also has its merits as it compensates for the low income tax regime since substantial government revenue is derived from land or land related activities, such as rate, property tax, stamp duty, sales proceeds of land and profits tax from property developers. In respect of public revenue, the high land price is a hidden form of tax. Owing to these compensatory advantages and other low factor costs in the early 1980s, it did not have an obvious impact on the economy during the period until government interventions were increasing in the mid-1980s. The limitation on sale of land to 50 hectare a year in the run-up to 1 July 1997 set out in the Sino-British Joint Declaration boosted the property and stock market value before the handover of the sovereignty. Property speculators and those who were "*anxious to show their support for Hong Kong*" (Wall Street Journal, 14 September 1998), worsened the bubble economy further by distorting the property price. The property price was seriously deviated from the normal price in a free market mechanism. The impact of government intervention on the economy became obvious in the Tung administration after 1 July 1997. The "defining policy" of increasing the supply of property for 85,000 units a year after 1 July 1997 together with the Asian Financial Crisis and the burst of economic bubble in 1998, plunged Hong Kong into recession. The originally "soft-landing" policy finally struck down the

property and stock value substantially. Intervention measures were later used to cure the damage of the intervention. As a result, the economy was further interfered with by the visible hand of the Government. In order to boost the real property market, the Government controlled the supply of land by freezing the land sales until 31 March 1999 (Lim, 1999). To encourage people buying real properties, the Government adopted policies to half the 10% deposit paid upon the signing of the preliminary sales and purchase agreement; and to remove the minimum 20% deposit of total purchase price after signing the formal agreement. It was hoped that these policies could stimulate the purchase of real properties.

In 1998, in order to minimise the adverse impact arisen from the speculators' attack on the currency (which is pegged with US Dollars), the Government intervened the stock market by the massive purchase of stocks and imposition of restrictions on short selling and future trades. The measures aimed at stabilizing the stock market and interest rates and preserving the currency peg. However, the intervention further undermined the creditability and consistency of government policies. In subsequent years, the HKSAR Government kept injecting billions of dollars to non-productive projects, such as the Cyber Port, Chinese Herbal Medicine Port etc. The projects were either dead or found wasting public money by the Audit Department.

In the 2007/08 budget, the HKSAR Government set up a HK\$300 million "Film Development Fund" to support the declining film industry including investing in film productions to a limit of HK\$3 million each. Subsequent to the setup of the film development fund, the HKSAR Government further spent HK\$2.4 billion from its foreign currency reserve to acquire 5.88% stake in the Hong Kong Exchanges and Clearing on 7 September 2007. The Government not only became the biggest shareholder, but also pushed the share price up more than 50% in a week's time. All these were straight forward and direct intervention to the private market sector.

(b) Fiscal Prudence Policy

The notable feature of public finance in Hong Kong is the very rapid growth of

both government revenue and expenditure. The revenue measured at current prices increased from HK\$82.1 million in the fiscal year 1946/47 to HK\$ 247,035 million in 2005/06 and the expenditure during the same period increased from HK\$85.6 million to HK\$233,071 million.

(i) Government Revenue

In Hong Kong, the revenue and expenditure are divided into operating and capital nature. The operating revenue is generated from direct tax, indirect tax and other charges. Direct tax consists of profits, salaries and property tax. Indirect tax consists of stamp duty, air passenger departure tax, hotel accommodation tax etc. Revenue other than those called “tax” are charges (fine and penalty) and fees (for public goods and services), which are in substance of “tax” nature based on benefit principle. Revenue of capital nature is mainly income generated from land transaction and various funds including Capital Works Reserve Fund, Development Loan Fund and Civil Service Pension Reserve Fund etc. Table 3 shows the government revenue by source. The Government’s operating revenue moved within a relatively narrow range of 13.4% of GDP in 1989-90 to 14.5% in 2005/06. It fell as low as 11.8% and 12.0% in 2001/02 and 2002/03 respectively; but rose over 14% in fiscal years 1992/93, 1993/94, 2003/04, 2004/05 and 2005/06. It reached the highest rate of 15% in the fiscal year 1997/98.

Table 3: Source for revenue from 1981/82 to 2005/06

Fiscal year	Revenue (HK\$ million)	Growth	Operating Revenue (% share)			Capital Revenue (% share)		
			Direct Tax	Indirect tax	Other revenue	Land Transactions	Direct, indirect & Others	Funds
1981/82	35,846.5		29.5	16.6	20.9	27.0	1.7	4.3
1982/83	32,267.7	-10.0	36.7	16.2	24.2	15.6	2.4	4.9
1983/84	32,813.2	1.7	34.8	22.9	25.3	6.9	2.7	7.4
1984/85	38,511.1	17.4	35.1	21.6	22.7	11.1	3.9	5.6
1985/86	43,695.3	13.5	38.0	25.3	20.1	8.9	2.0	5.6
1986/87	48,602.7	11.2	38.6	26.7	20.9	0.7	2.5	9.7
1987/88	60,876.9	25.3	40.7	27.0	20.3	0.7	1.0	10.2
1988/89	72,658.5	19.4	41.4	25.6	22.0	0.5	1.5	9.5
1989/90	82,430.2	13.4	40.7	24.7	23.7	0.3	0.9	9.8
1990/91	89,523.8	8.6	40.6	27.7	22.7	0.3	1.2	7.7
1991/92	114,699.9	28.1	39.1	28.8	19.2	0.4	0.9	11.5
1992/93	135,310.9	18.0	40.7	30.1	17.3	0.2	0.9	10.7
1993/94	166,601.4	23.1	39.3	28.3	16.3	0.2	2.3	13.6
1994/95	174,998.6	5.0	42.5	24.1	17.5	0.2	2.0	13.7
1995/96	180,045.1	2.9	43.0	23.2	17.5	0.2	1.0	14.9
1996/97	208,358.0	15.7	40.3	26.1	15.6	0.2	1.2	16.6
1997/98	281,226.0	35.0	32.5	23.2	17.0	6.4	1.4	19.6
1998/99	216,115	-23.2	35.0	17.7	20.1	0.0	1.7	16.5
1999/2000	232,995.0	7.8	28.7	18.7	27.8	0.0	1.4	23.4
2000/01	225,060.3	-3.4	32.8	22.6	20.7	0.0	6.3	17.6
2001/02	175,559.8	-22.0	44.3	25.8	16.1	0.0	3.0	10.8
2002/03	177,489.0	1.1	41.1	22.1	23.1	0.0	2.3	11.3
2003/04	207,338	16.8	38.8	24.4	21.0	0.0	1.6	14.2
2004/05	263,591	27.1	36.7	22.1	12.6	0.0	1.4	27.3
2005/06	247,035	-6.3	45.2	25.2	12.4	0.0	0.2	15.3

Source: Census and Statistics Department

From Table 3, we can find that the government gets most of its revenue from direct taxes. The direct taxes are mainly income-based taxes with an average of 40.8% for the fiscal years from 1989/90 to 1996/97 and an average of 32.3% for the fiscal years from 1997/98 to 2000/01. It rose to an average of 41.2% for the years 2000/01 till 2005/06. We note that the high percentage in 2001/02 and 2002/03 was likely because the total revenue was low.

The largest category amongst the direct taxes is profits tax, which accounted for an average of 24.5% from 1989/90 to 1997/98, an average of 19% between 1997/98 and 2000/01 and rose to an average of 24.2% after 2000/01. Among direct taxes, the property tax revenue had not recovered to the same level as other

income tax after 1996/97 because the property market, either the buy/sell or rental market, has not recovered from the Asian Financial Crisis in 1998.

The indirect taxes are primarily consumption-based taxes and government charges, it moved stably in the range of 24.1% to 30.1% between the years 1988/89 to 2005/06 except for the years 1998/99, 1999/2000 and 2004/05 (their portion to the government revenue was 20.2%, 20.8% and 22.1% respectively).

In respect of revenue from natural resources, land is almost the only natural resource that Hong Kong has. Land related transactions are the major revenue source that the Government has relied on. However, revenue from land transactions was not that significant between 1980s and 1997 due to the restricted sale of land in accordance with the Sino-British Joint Declaration. Half of the revenue was placed in the Land Fund before 1997 and was transferred to the Hong Kong SAR Government in 1997.

Table 4: Revenue to GDP (current price) in percentage

Year	GDP	Direct tax	Indirect tax	Other revenues	Land Transactions	Capital	Funds	Total revenue/GDP
	(billions)	%	%	%	%	%	%	%
1989/90	549,474	6.1	3.7	3.6	0.0	0.1	1.5	15.0
1990/91	617,511	5.9	4.0	3.3	0.0	0.2	1.1	14.5
1991/92	718,242	6.2	4.6	3.1	0.1	0.1	1.8	16.0
1992/93	834,253	6.6	4.9	2.8	0.0	0.2	1.7	16.2
1993/94	959,361	6.8	4.9	2.8	0.0	0.4	2.4	17.4
1994/95	1,065,241	7.0	4.0	2.9	0.0	0.3	2.2	16.4
1995/96	1,135,560	6.8	4.2	2.3	0.0	0.2	2.4	15.9
1996/97	1,263,907	6.6	4.7	2.1	0.0	0.2	2.7	16.5
1997/98	1,365,669	6.7	5.2	3.0	1.3	0.3	4.0	20.6
1998/99	1,274,964	5.9	3.4	4.5	0.0	0.3	2.8	17.0
1999/2000	1,286,100	5.2	3.8	4.6	0.0	0.3	4.2	18.1
2000/01	1,314,480	5.6	4.2	3.2	0.0	1.1	3.0	17.1
2001/02	1,287,343	6.0	3.9	1.8	0.0	0.4	1.5	13.6
2002/03	1,273,581	5.7	3.4	2.9	0.0	0.3	1.6	13.9
2003/04	1,241,313	6.5	4.1	3.5	0.0	0.3	2.4	16.7
2004/05	1,305,917	7.4	4.5	2.5	0.0	0.3	5.5	20.2
2005/06	1,408,115	7.9	4.4	2.2	0.3	0.0	2.7	17.5
<i>Source: Census and Statistics Department</i>								

Table 4 shows the relationship of revenue to GDP. The direct tax was stable from 1989/90 to 1997/98. It was in the range of 5.9% to 6.7%. However, it moved

downward from 1998/99 until rising again to 6.5% in 2003/04. The revenue to GDP rose to 7.4% and 7.5% in 2004/05 and 2005/06, respectively. The downward movement was due to the substantial increase in personal allowances and tax deductions, expansion of the tax bands, and lowering of the tax rates of salaries and profits tax in 1998/99 which narrowed the tax base by dropping a large working population out of the tax net. The direct tax revenue to GDP then fell below 6%. Coupled with the increase in government expenditure in four years from 1998/99 to 2002/03, the resulted deficits were claimed structural by the HKSAR Government despite that the surplus has returned from 2003/04. The tax cut in the late 1990s was not financed by a reduction of spending simultaneously. The “narrow” tax base was caused by the tax cut and the broadening of the expenditure base, which was a hidden tax in nature. Friedman gives a good account for tax cuts:

“The tax cut is being financed by the unlegislated increase in the effective tax rate produced in a growing economy by a graduated income tax combined with incompleting indexation of taxes for inflation. Taxes are going up, not down.”(Friedman, 1997b).

In respect to indirect tax, its percentage share to GDP declined from 5.2% in 1997/98 to a narrow range of 3.4% to 4.1% for the years 1998/99 to 2003/04. “Other revenue” gradually declined in the 1990s. The large increase in 1998/99 was because the inclusion of the Land Fund in accordance with the Sino-British Joint Declaration. The decline in 2001/02 was the result of the freeze of government fees and charges.

After the consecutive deficits for four years from 1998/99 to 2001/02, the Government pointed out the tax burden was only borne by a small group of taxing population as depicted in Table 5(a):

Table 5(a): The taxing population (salaries tax)

Fiscal Year	Tax Paying Population	Non-Tax Paying Working Population	Paying Standard Tax		% of Salaries Tax paid by Tax population (in Bracket of 100,000)					
			% of Working Population	% of Salarie s Tax	1st	2nd	3rd	4th	5th	The Rest
1997/98	1,330,000	1,830,000	2.0	43.9	54.8	16.8	8.3	6.7	3.7	9.7
1998/99	1,150,000	2,000,000	0.3	19.5	62.4	15.1	7.3	5.6	3.4	6.2
2001/02	1,200,000	2,000,000	0.3	20.0	61.4	16.1	7.8	5.0	2.5	7.2
2002/03	1,200,000	2,000,000	0.4	23.0	62.1	17.5	8.6	4.9	2.9	4.0
2003/04	1,245,000	1,955,000	2.2	30.0	59.2	17.4	9.5	4.7	4.4	4.8
2004/05	1,260,000	2,040,000	1.27	35.8	57.0	18.0	10.0	6.1	3.4	5.5
2005/06	1,220,000	2,150,000	1.4	38.3	58.2	16.3	10.0	6.6	3.5	5.4
2006/07	1,260,000	2,240,000	1.0	35.8	59.6	16.0	9.3	5.8	3.8	5.5
<i>Note:</i>	<i>1997 figures are actual revenue figure, others are based on provisional assessments. *The stand rate was 15.5% in 2003/04 and 16% in 2004/05</i>									
<i>Sources:</i>	<i>The 1999/2000, 2002/03, 2003/04, 2004/05 and 2005/06 Budget Background Information for the Financial Secretary's Consultations with Legislative Council Members, November 1998, December 2001, October 2002, October 2003, November 2004, November 2005 and November 2006 respectively.</i>									

In Table 5(a), it can be seen that the portion of tax paying population among the whole working population is decreasing compared with 1997/98 and a large portion of tax revenue is derived from smaller group of taxpayers. Apart from showing the narrowing taxing population, the underlying message in the table is that the income inequality becomes more serious i.e. less people earn sufficient income to pay tax. The Gini Coefficient rose from 0.518 in 1996 to 0.533 in 2006 (source from Census and Statistics Department 2007). It not only reached its historical high in Hong Kong, but also was the highest among the developed countries. Being a measurement in which “0” is perfect equality and “1” is total inequality, the rising Gini Coefficient is an alarm to the changing social structure which indicates that the social discontent is increasing. Even though Becker (1995: 24) argues that “*the income inequality could be an engine that drives an economy toward more rapid economic growth.*”, it is seemingly supported by the Hong Kong’s experience (Lui 1997) that the growth is at the expense of the lower level income group. However, income inequality is beyond the scope of this project.

Table 5(b): The taxing population (profits tax (corporation))

Assessable Profits (HK\$ Million)	Fiscal Year 1999/2000			Fiscal Year 2000/01			Fiscal Year 2001/02			Fiscal Year 2003/04		
	Corporations		% of Total Tax Yield	Corporations		% of Total Tax Yield	Corporations		% of Total Tax Yield	Corporations		% of Total Tax Yield
> 50M	500	1.0%	59.9%	600	1.1%	60.6%	500	1.0%	59.6%	600	1%	60.3%
>\$30M to \$50M	300	0.6%	5.9%	400	0.8%	6.3%	300	0.6%	6.1%	400	0.7%	6.5%
>\$20M to \$30M	500	1.0%	5.1%	500	1.0%	5.0%	500	1.0%	5.0%	500	0.9%	5.0%
>\$10M to \$20M	1,200	2.3%	7.9%	1,300	2.5%	7.8%	1,200	2.3%	8.0%	1,500	2.6%	8.1%
>7.5M to 10M	800	1.5%	3.1%	800	1.5%	3.1%	800	1.5%	3.2%	900	1.6%	2.9%
>5M to 7.5M	1,400	2.7%	3.8%	1,500	2.9%	3.7%	1,300	2.5%	3.5%	1,600	2.8%	3.7%
>3M to 5M	2,300	4.5%	4.1%	2,400	4.5%	3.9%	2,300	4.4%	4.1%	2,700	4.7%	4.0%
>2M to 3M	2,500	4.8%	2.7%	2,500	4.7%	2.6%	2,400	4.6%	2.8%	2,700	4.7%	2.5%
>1M to 2M	5,200	10.1%	3.4%	5,400	10.2%	3.1%	5,400	10.3%	3.5%	6,000	10.4%	3.2%
<1M	36,900	71.5%	4.1%	37,400	70.8%	3.9%	37,600	71.8%	4.2%	40,900	70.8%	3.8%
<i>The 2002/03, 2003/04, 2004/05 and 2007/08 Budget Background Information for the Financial Secretary's Consultations with Legislative Council Members, December 2001, October 2002, October 2003, and November 2006 respectively.</i>												

Table 5(b) shows the taxing population of corporations. Again, we can find that the major tax burden rests on the shoulder of few large corporations. It strengthens the message that the “*income inequality*” is also widened in the business world.

(ii) Government Spending

Expenditure, like revenue, is divided into operating and capital expenditure. Operating expenditure includes recurrent expenditure, subventions (social welfares, education etc.) and other operating expenditure. Capital expenditure is of a non-recurrent nature including plant, subventions, equipment and works.

Table 6: Government expenditure to GDP

(HK\$ in million)

Year	GDP at current price	Operating expenditure	Capital expenditure	Percentage of operating expenditure to GDP at current price	Percentage of capital expenditure to GDP at current price	Percentage of capital expenditure to GDP at current price
1989/90	549,474	50,206	21,159	9.1%	3.9%	13.0%
1990/91	617,511	61,469	24,088	10.0%	3.9%	13.9%
1991/92	718,242	71,677	20,515	10.0%	2.9%	12.9%
1992/93	834,253	85,024	28,308	10.2%	3.4%	13.6%
1993/94	959,361	96,958	50,480	10.1%	5.3%	15.4%
1994/95	1,065,241	106,620	57,535	10.0%	5.4%	15.4%
1995/96	1,135,560	121,903	61,255	10.7%	5.4%	16.1%
1996/97	1,263,907	135,853	46,827	10.7%	3.7%	14.4%
1997/98	1,365,669	160,566	33,794	11.8%	2.5%	14.3%
1998/99	1,275,964	177,406	61,950	13.9%	4.9%	18.8%
1999/00	1,286,100	175,921	47,122	13.7%	3.7%	17.4%
2000/01	1,314,480	186,686	46,207	14.2%	3.5%	17.7%
2001/02	1,287,343	198,743	40,147	15.4%	3.1%	18.5%
2002/03	1,273,581	200,310	38,867	15.7%	3.1%	18.8%
2003/04	1,241,313	203,234	44,232	16.4%	3.6%	20.0%
2004/05	1,305,917	196,906	45,329	15.1%	3.5%	18.6%
2005/06	1,408,115	192,462	40,609	13.7%	2.9%	16.6%
<i>Source: Census and Statistics Department (revision date 26 November 2006)</i>						

Table 6 shows the government operating expenditure at current price increased from 9.1% of GDP in 1989/90 to 11.8% in 1997/98 and to the peak of 16.4% of

GDP in 2003/04. It dropped to 13.7% in 2005/06. In respect to the total government expenditure to GDP, it rose from 13.0% in 1989/90 to 14.3% in 1997/98 and to the peak of 20.0% in 2003/04. It fell to 16.6% in 2005/06. It is noted that the government expenditure to GDP is on an increasing trend after 1992/93.

The last Governor, Chris Patten, expressed that the lower level of public spending to GDP was one of the key factors of economic success in Asia. However, he noted that the lower proportion of public spending might be in part a consequence of a less advanced stage of economics development. He put Japan, whose public spending to GDP was close to those in Europe and North America, as an example of a well developed economy. He expected that public spending in Asia might edge up in response to growing demands for public services (Patten, 1998: 227).

However, the increase in government expenditure attracted criticism from the Chinese Government during the transition period of the sovereignty handover. In 1995, Chen Zou'er, the leader of the Joint Liaison Group on the Chinese side, criticised the Hong Kong government's increase of social welfare expenditure, jumped 66.5 percent in real terms. Mr. Chen said it was analogous to a Formula One racing car that had sped out of control. It would be bound to crash and killed all the passengers if it went on that speed. The Chinese government was worried that the increase in the government expenditure would leave a great burden to the Hong Kong SAR Government after the return of sovereignty.

The increase in expenditure gave rise to a question of the structural financial deficits. The deficits were caused by several reasons. The increase in government expenditure was one of the reasons. The increase in individuals tax exemptions and widening of the tax bracket were the other. The economic downturn after 1997, including the Asian Financial Crisis, the burst of the economic bubble and the SARS outbreak, is the main reason for the deficits.

Table 7: Public Expenditure by Function

Fiscal Year	Gross Domestic Product (GDP)	Total Public Expenditure (HK\$M)	Percentage Share in Total Public Expenditure (TPE)										TPE/ GDP
			Community and External Affairs	Economy	Education	Environment	Health	Housing	Infrastructure	Security	Social Welfare	Support	
1986/87	298,391	47,930	4.4	5.6	18.0	3.3	9.1	12.1	13.7	15.6	5.4	12.9	16.1
1987/88	400,059	53,636	4.5	5.9	17.7	3.3	9.3	13.1	13.6	15.1	5.3	12.3	13.4
1988/89	519,081	64,799	4.3	5.8	18.0	3.1	8.8	15.1	13.3	14.8	5.4	11.4	12.5
1989/90	549,474	81,945	4.1	5.3	16.4	3.9	8.9	14.1	16.7	14.1	5.3	11.2	14.9
1990/91	617,511	95,198	4.4	5.7	17.4	4.7	9.7	13.0	12.1	14.5	5.6	12.8	15.4
1991/92	718,242	108,012	3.7	5.7	18.0	5.1	9.9	11.6	12.8	13.8	5.9	13.5	15.0
1992/93	834,253	123,493	3.6	6.2	18.0	5.1	10.0	10.5	13.8	13.2	5.9	13.0	14.8
1993/94	959,361	155,207	3.2	8.1	16.4	4.5	11.9	10.7	14.5	11.2	5.9	13.7	16.2
1994/95	1,065,241	165,950	3.3	4.8	17.4	4.9	11.6	11.9	15.4	11.4	6.6	12.6	15.6
1995/96	1,135,560	191,338	3.2	5.0	17.6	5.2	12.7	9.97	13.6	11.4	7.4	13.9	16.8
1996/97	1,263,907	211,248	3.6	5.5	17.8	5.4	11.9	11.5	10.6	11.5	8.5	13.6	16.7
1997/98	1,365,669	234,780	3.5	7.3	20.0	5.6	11.9	10.5	9.0	10.1	9.3	12.9	17.2
1998/99	1,274,964	266,488	3.2	8.0	18.2	5.0	11.8	14.6	8.7	9.4	9.9	11.2	20.9
1999/00	1,286,100	269,484	3.4	4.6	18.7	4.5	11.8	17.0	8.5	9.6	10.3	11.2	21.0
2000/01	1,314,480	267,507	3.1	4.7	19.2	4.2	12.2	15.9	8.5	10.0	10.5	11.6	20.4
2001/02	1,287,343	269,359	3.1	5.1	19.4	4.1	12.7	11.9	9.3	10.2	11.2	13.0	20.9
2002/03	1,273,581	263,520	3.1	5.2	20.8	4.3	12.6	9.1	9.3	10.3	12.3	13.0	20.7
2003/04	1,241,313	271,098	3.0	5.2	21.1	4.0	12.6	9.2	10.0	9.8	12.3	12.5	21.8
2004/05	1,305,917	257,137	3.0	5.1	21.0	3.2	12.5	7.0	11.2	9.9	13.0	13.4	19.7
2005/06	1,408,115	250,255	3.28	5.5	22.2	3.1	12.6	6.3	10.3	10.0	13.5	12.4	17.8

The average of TPE/GDP from 1989/90 to 1997/98 is **15.4%** and from 1998/99 to 2005/06 is **20.4%**

Source: Financial Service and the Treasury Bureau HK Annual Digest of Statistics

Public expenditure comprises government expenditure (i.e. all expenditures charged to the General Revenue Account and financed by the Government's statutory funds excluding Capital Investment Fund), and expenditure by the Trading Funds and the housing Authority. It does not include expenditure by those organisations (including statutory organisations) in which the Government has only an equity position, such as the Airport Authority, the MTR Corporation. Similarly, advances and equity investments from the Capital Investment Fund are excluded as they do not reflect the actual consumption of resources by the Government.

Having realised the increasing public expenditure resulted in deficits, the former Financial Secretary, Mr. Antony Leung, set the public expenditure at not more than 20% of GDP in his 2002/03 budget. Public expenditure includes government expenditure (less advances from equity investments in the Capital Investment Fund), plus expenditures by the Trading Funds, Housing Authority and previous Urban and Regional Councils up to 31 December 1999. Public expenditure is a major indicator of the extent of the government's involvement in the economy, i.e. the size of the government. Table 7 shows the major components of public expenditure and the percentage shares since 1986/87. It can be noted that the major increase of government spending was education and health.

The average public spending for the fiscal years from 1986/87 to 1997/98 was 15.4% while it rose to an average of 20.4% for the fiscal years thereafter up to 2005/06. Among the expenditures, education rose from 18.0% of the total expenditure from 1986/87 to 22.2% in 2005/06 while health care rose from 9.1% to 12.6% for the same period. However, these two figures took 20.3% and 26.9% in the revenue for the fiscal year 1997/98 and 2005/06 respectively.

To what extent the level of government spending is said to be optimal i.e. the best balance of maintaining the social order and the free economy? There is no easy answer of what the desirable level of government spending is. In the absence of governments or too small size of governments, which is analogous to anarchy, economic activity tends to be non-productive since the people's wealth could not be accumulated and protected. When the government size is too large, it discourages private investment. The invisible hand of the market does not work effectively. In either case, no economic affluence will be obtained. Friedman (1997b, A.14) compared Hong Kong with the USA in the essential role of government to play in a free and open society, he concluded that the marginal contribution going from 15% of the national income to 50% was negative.

The Government's over-expenditure is a form of hidden tax since the deficits will inevitably be financed by an increase in tax i.e. either broadening the tax base or increasing the tax rate. In order to measure whether the Government expenditure of the Hong Kong SAR is at an optimal level, I used the Armeij Curve, which was

developed by Arthur Laffer to depict the bell-shaped relationship between national output (Real GDP) and the government and private decisions (government spending as a percent of GDP) on the allocation of resources (Armey, 1995). Based on the formula relating government spending as a percentage of total output (G) to total output (real gross domestic)(O), by adding the time trend (T) and unemployment variables (U), the Armey Curve equation is as follows:

$$O = A + bG - cG^2 + dT - eU.$$

Where:

O = Real GDP

G = total output

T = Time trend – 1 for the first year, 2 for the 2nd year etc

U = unemployment rate.

Using the data from 1981/82 to 2005/2006, it gives the following Armey curve equations for the Hong Kong economy (Figure 1), which results the optimal government spending as per output are 18.18% and 17.20% at year 2000 price and current price respectively.

Figure 1**Armey Curve equations for the Hong Kong Economy**

(The results of optimal government spending by applying the equation developed by Arthur Laffer and using the data from 1981/82 to 2005/06)

At year 2000 price :

$$\text{Output} = 163,113.81 + 3,461,035.95G - 8,677,404.23G^2 + 49,439.52T - 2,313,031.4U$$

(t-statistics) (0.34) (0.53) (0.38) (31.90) (2.06)

At current price :

$$\text{Output} = 1,705,604.05 + 24,760,218.39G - 69,606,580.56G^2 + 62,548.36T - 8,018,712.12U$$

(t-statistics) (2.66) (2.80) (2.17) (15.73) (2.37)

STATISTICS:**At year 2000 price**

Regression statistics	
R	0.9936
R ²	0.9871
Adjusted R ²	0.9846
Standard Error	43.29
Observations	25

ANOVA						
	Df	SS	MS	F	Significance (P-value)	F- Crit
Regression	4	2,978,517.95	719,629.49	384.07	1.34	
Residual	20	37,474.05	1,873.70			
Total	24	2,915,992.00				
	Coeff	Standard Error	t-Stat	P-Value	Lower limit 95%	Upper limit 95%
Intercept	163.00	479.84	0.34	0.7376	-837.93	1,163.96
G	3,463.15	6,561.36	0.53	0.6034	-10,223.61	17,149.90
G ²	-	22,715.30	-0.38	0.7061	-56,071.36	38,695.20
	8,688.08					
Time	49.44	1.55	31.90	0	46.21	52.67
Unemployment	-	1,123.78	-2.06	0.05	-4,655.91	32.43
	2,311.74					

At current price

Regression statistics	
R	0.9783
R ²	0.9572
Adjusted R ²	0.9486
Standard Error	101.3715
Observations	25

ANOVA						
	Df	SS	MS	F	Significance (P-value)	F- Crit
Regression	4	4,592,814.87	1,148,203.72	111.73	0	
Residual	20	205,523.62	10,276.18			
Total	24	4,798,338.48				

	Coeff	Standard Error	t-Stat	P-Value	Lower Ltd 95%	Upper Ltd 95%
Intercept	-1705.1236	639.28	-2.67	0.015	-3,038.64	-371.61
G	24,753.3681	8,836.06	2.80	0.01	6,321.68	43,185.06
G ²	-	32,082.23	-2.17	0.04	-136,509.17	-2,664.44
	69,586.80504					
Time	62.5517	3.98	15.73	0	54.26	70.84
Unemployment	-8,018.0353	3,389.21	-2.37	0.03	-15,087.80	-948.27

(iii) *Rationale behind the increase in government spending*

Since Adam Smith, many prominent economists and political scientists have advocated the market oriented and smaller role for government policy (Friedman, 2002: ix). Even though the doctrine of centrally planned economy adopted by some third world countries after the Second World War has been proven as not working as efficient as the free economic theory, government spending in most countries has grown rapidly in recent decades. In Hong Kong, the government spending grew rapidly from a percentage as low as 13.4% of GDP in 1987/88 to 21.8% of the GDP in 2003/04 (Table 7).

The increase in government spending is a world phenomenon after the Second World War. Economist tried to explain this phenomenon but failed to explain the trend especially when comparing the period before the second quarter of the century and thereafter. Peacock and Wiseman (1961) suggest the “*ratchet effect*”

but this war-effect theory of government growth is hardly applied to our economy. Hong Kong has had no much spending burden on the defence, since it was substantially provided by Britain in the colonial days and provided by China after the handover of sovereignty in 1997. Gordon Tullock used the data of the US Gross National Product (GNP) for the period from 1790 to 1990 to test some economic theories on government spending (Tullock, 2002), but none of the theories could satisfactorily explain the phenomenon that the government spending grew rapidly in recent years.

Higgs (1987) holds the view that governments tend to grow at a fairly regular rate under normal circumstances but expand at a far more rapid pace when facing a crisis. Then, when the crisis subsides, the size of government reduces, but not back to the pre-crisis levels. Thus, "*ratchet effect*" in times of crises to the size of government is at a rate greater than would otherwise be the case before the crisis. To a certain extent, this "*leviathan*" theory may explain the phenomenon of the economic crises (Asian Financial Crisis, SARS outbreak, etc.) in Hong Kong after 1997.

A contending view holds that the recent growth of governments is the consequence of broad social trends such as increasing economic equality, the emergence of an educated middle-class, and increasing costs of government administration (Peltzman, 1980, p.209 – 287; Meltzer and Richard, 1978, p.111-118; Meltzer and Richard, 1981, p.924-927; Kau and Robin, 2002: p.389-402; DeMuth, 2000; DeMuth, 2002; Becker and Mulligan, 1999). Some hold the view that the demands of electorates, which are large enough to use the political process for the benefit of various social, regional, and occupational subgroups, may explain the growth of government size in Hong Kong after 1997. The election system in Hong Kong shows this phenomenon. Only 800 people in Hong Kong from different groups have the voting right to elect the Chief Executive. Half of the Legislative Council members are elected by various functional groups and the district council members, who are substantially appointed by the Government. These groups with privileged voting rights may "lobby" the Government to transfer wealth to them, such lobbying is called "rent-seeking" by economists, especially when the Government needs their votes to support or at the

election time of the Chief Executive. The political system may make the Government hand out public money to a few privileged pressure groups whenever it needs support to its policies.

(c) TAX SYSTEM

Hong Kong's tax system is simple, and the tax rate is low. It does little to serve the re-distribution of income and wealth purpose, such as healthcare and retirement income. Other than its simplicity and low tax rates, the features of our tax system are in its territorial and scheduler system. For territorial system, it means that only income "arising in or derived from" Hong Kong is chargeable to tax. In other words, it adheres to the "source" of the income rather than "residence" or "citizenship" status of the taxpayer. Income from non-Hong Kong sources but received by a resident in Hong Kong is excluded. For scheduler system, it means that tax is levied on specified income, including profits, salaries and property. Under personal assessment, taxpayers may elect by grouping all husband and wife's income from various sources for assessable income to compute their tax as that in salaries tax, under which the taxpayers can claim personal allowances. Their tax liability will be the lower of the tax calculated by the standard rate before personal allowances or by a sliding scale of marginal rates after personal allowances.

The revenue from any tax is the product of the tax rate applied to the tax base. The most common bases for taxes are income, consumption, and capital or wealth. Taxes on income or consumption are taxes applied to current transactions whereas taxes on capital or wealth are on the value of accumulated holdings. Under Hong Kong's financial system, the major government revenue comes from income-based taxes. They are profits tax, salaries tax and property tax. Interest tax was abandoned in 1989/90 and the estate duty (wealth tax) was abandoned in 2005/06.

Owing to our territorial tax system, only income derived from or arisen in Hong Kong is taxed. It involves some complicated technical issues and is normally based on the precedent court decisions, which may be changed by the change of

business practice and by different interpretation of the learned judges from time to time. The technical issue of sources of income is beyond the scope of this project. However, what should be highlighted is that, to a certain extent, due to the aggressiveness of the tax authority and the high legal costs in combating the tax determination, the interpretation of tax law is vested in the hand of the tax officers. It is costly for taxpayers to appeal its tax grievance to the court. In consideration of the low tax rate, the costs of appeal normally outweigh the benefits. The high appeal cost may damage the effects of the simple tax system.

To know more about how the tax policies affect the Hong Kong economy, we need to know about the tax structures, especially those major components in the government revenues. Direct tax is the largest source of government revenue. Its main components are all income based taxes, including profits tax, salaries tax and property tax. Interest tax was repealed with effect from 1 April 1989. Since then interest received in the course of business would then be assessed under profits tax. With effect from 22 June 1998, tax exemption has been further granted to business entities for interest income, which is derived from deposit placed in approved local financial institutes, by the *Exemption from Profits Tax (Interest Income) Order 1998 made under section 87 of the Inland Revenue Ordinance*.

Profits tax is a tax on business profits adjusted from accounting profits charged at two flat rates: one for incorporated business and the other for unincorporated business. The profits tax rate for incorporated business has been charged 1% to 1.5% higher than that of unincorporated business. In Hong Kong's tax history, the flat rate lies between 15% and 18.5%. In 2007/08, the profits tax for corporations is 17.5% while standard tax for unincorporated business is 16%. The corporation and unincorporated business rates have been enacted to 16.5% and 15% respectively for the year 2008/09. This standard rate for unincorporated business also applies to salaries tax and property tax.

Salaries tax is charged on income arising from employment. Due to the territorial system, only those salaries income sourced from Hong Kong are chargeable to tax. In principle, outgoings and expenses wholly, exclusively and necessarily incurred in the production of assessable employment income are theoretically

deductible from assessable income, but the deductibility test is not easy to get through. It follows that taxpayers are allowed to deduct those statutory and concessionary deductions as well as their personal allowances. The statutory and concessionary deductions are personal exemptions that the government employs as part of its tax policy. After the deductions and personal allowances, the net chargeable income will be charged at marginal rates, but the tax will be limited to a maximum of net assessable income before personal allowance at the standard tax. Statutory deductions include self-education expenses while concessionary deductions include charitable donations, elderly residential care expenses, home loan interest and retirement fund contributions.

In some countries such as the USA and Canada, property taxes are levied on accumulated wealth or stocks of wealth. In Hong Kong, property tax is an income-based tax. It is charged at the standard rate on rental income generated from land or buildings after 20% statutory deduction and government rates.

Both profits tax and property tax are charged at standard tax rate. Taxpayers who want to enjoy the benefits of graduated tax rates and deductible personal allowances that are available only in salaries tax, they may elect personal assessment, under which the taxpayers may group all the incomes of husband and wife together for assessment. Personal assessment is not an assessment itself but a relief for taxpayers to compute their tax liability on the total of their net assessable value of their property, unincorporated business profits, and assessable employment income, net of prescribed deductions and personal allowances.

Indirect tax is the second largest source of revenue which was ranged from 20% to 30% during the years from 1989/90 to 2005/06. It is particularly important during the slowing economy. It remains rather stable than direct tax. The major component of indirect tax consists of Stamp Duties, Bets and Sweeps Tax, Duties, General Rates, Motor Vehicle Tax, etc. Among which, Stamp Duty and General rate are closely linked to the property and financial markets.

Stamp Duty levies on instruments evidencing transactions of financial instruments and properties, including buy/sell and lease of property. It is more volatile than

the other indirect taxes because its connection to the stock and property markets. Very often, the Government exploits it to stimulate or cool down the property transactions.

General rates levies on properties. It is similar to that of property tax in other countries, like the USA and Canada. They are a wealth tax charging at a percentage of the rateable value which is estimated annual rental value of a property at valuation reference date as the property was then vacant and to let. For the fiscal year 2007/08, the chargeable rate is 5% at the designated valuation reference date as of 1 October 2006. The rate has been used frequently as a tax relief when the economy is slowing down or the fiscal reserve is large enough to face financial challenges. For example, the rates for first two quarters of the fiscal year 2007/08 are exempt in response to the loud cry of tax reduction for a huge surplus of HK\$5.5 billion resulted from fiscal year 2006/07. Also, the rate for the last quarter of 2007/08 has just been announced to be exempt in the Policy Address 2007.

One of the main factors making Hong Kong succeed was its free trade policy, which refers to its no tariff policy on general imports except that there are duties on liquors, tobacco, hydrocarbon oil and methyl alcohol as well as the import tax on motor vehicles. The duties on this limited variety of goods generated 2.5% to 6.5% of the revenue while the import tax on motor vehicle raises 1% to 3.7% of the revenue during the fiscal years of 1999/2000 to 2005/06. In addition to generating revenue to keep the direct tax level down, these selected custom and excise taxes also serve the purposes of achieving other goals. Some of these excise taxes are normally designed specifically to discourage consumption by inflating the price to consumers, such as tobacco and liquor (however, there may be exceptions like the recent budget 2007/08, the duty on wine was reduced so as to stimulate consumption of wine by lowering the price, but it is another result of a typical “rent seeking” act that the duty reduction is used to please the voters in the functional section of the Chief Executive election. After the duty is cut, the price remains unchanged with an excuse that the liquor which suffered from the old duty has not been completely sold out. In some situations, the consumption of these goods creates costs to society that would not be borne by the purchaser, such

as the increase in healthcare expenditure on diseases caused by the increased consumption on wine. Some excise taxes are used either to simulate or discourage consumption, dependent upon the economic recession or boom. For example, to control motor vehicles on the street, the gasoline duty and motor vehicle tax will increase. In a slowing down economy, the import tax on motor vehicles tends to lower to encourage consumption. To cope with environmental protection, the duty on leaded petrol is levied higher than unleaded petrol. A plastic bag tax will be imposed commencing from 1 January 2008. To balance the competitive edge by not pushing the cost high, the duty on diesel is lower than gasoline since most commercial trucks are using diesel. Moreover, there is a refund of duty on light diesel oil consumed by the public bus service.

Gambling is popular in almost all Chinese societies. As a major open city in China, the bets and sweeps tax is one of the major revenues in indirect tax. The tax is charged on the net stake receipts derived from authorised betting on horse racing and football matches, contributions or subscriptions to authorised cash-sweeps, and the proceeds on authorised lotteries. The highest duty is charged on betting on horse racing, it ranges 72.5% to 75% for bets in Hong Kong with discounted rates from 40% to 50% for bets outside Hong Kong, such as Macau. The rates for Cash-Sweeps, Lotteries (Mark Six) and Betting on Football Matches are 30%, 25% and 50% respectively. While bets and lotteries appear to be a painless supplement to government finances, they have come under criticism of encouraging gambling which has caused a numerous family tragedies in Hong Kong. In respect of the tax itself, it appears that low-income families spend a higher percentage of their income on bets and lotteries than high-income families do, making the burden of this activity regressive. However, the burden is said to be on a voluntary basis as gambling itself is a personal habit.

In addition to taxes, governments obtain revenue from other sources such as user charges and license fees. Compared to taxes, these revenue sources are stable. Even though it only moves in a narrow range between 2.0% to 3.1% of the revenue, but they can nevertheless be important. .

User charges can involve things such as fees for parking lots, tolls for roads or bridges, tuition for optional education services, and so forth. They are based on benefit principle having the advantage of raising revenue without adding to the general tax burden. User charges work under the market mechanism. It sends signals to the government which services that people require and how much they value those services. To apply user charges, it must be clear who benefits from the activity and it must be possible to levy the charges in an economical fashion. It would seem foolish, for example, to impose a user fee when the cost of collecting the fee exceeds the revenue from it unless the services are of public interest.

Licensing and the associated fees cover a variety of situations. In some cases, the licence is imposed to regulate specific activities such as the operation of motor vehicles or catering business. Without a licence, the activity is forbidden so that the licence is a necessary condition for the activity, but no specific government service is provided. The extent to which inspections or qualifications associated with obtaining the licence is an indication of the importance of the regulatory function of a licence activity. Fees are charged on the association.

Governments can also obtain revenue from the sale of goods or services that are only available from the government such as water and mass transit rail.

While income taxes can be thought of as taxes on *potential* consumption, sales and excise taxes are taxes on *actual* consumption. A concern both with general sales taxes and with selective excise taxes is tax avoiding or reducing behaviour by consumers. When the same or similar products can be purchased nearby, consumers tend to make purchases in a nearby jurisdiction where the taxes are lower. The growth of internet and e-shopping, consumers can avoid excise and sales tax by purchasing through internet. It is evidenced in most countries, such as Singapore and European countries that a GST shifts the consumption economy from a high tax rate jurisdiction to a low tax rate jurisdiction.

5.3 GOODS AND SERVICES TAX

(a) The Reasons for implementing a GST

In July 2006, the Government released a nine-month Consultation Document for the implementation of a GST. It stressed that Hong Kong's prosperity relied on its low and competitive tax system, reliable provision of public services and sound government finance. It also stated that the rapid recovery of the economy in the last two years (2004/05 and 2005/06) was attributable to, among other things, our simple, predictable and low rate tax system. However, the Government insisted on the need for a GST. It appeared contradictory to itself and opened the Government to the criticism that the GST would complicate the simple and low tax rate system that Hong Kong had relied on for its success. Chris Patten remarked that in the early 1990s when he was the governor, the economy thrived under his rule in the absence of a sales tax, the then financial secretary and the present Chief Executive of Hong Kong SAR, Donald Tsang, "was even able to cut tax, increase spending and build up reserves without wrecking the economy". According to the Government, the need for a GST was based on three main reasons, i.e. (i) the deficiency in the financial system was structural; (ii) the tax system was narrow; and (iii) implementing GST was an international trend.

(i) Cyclical versus Structural deficits

When government revenues cannot cover the expenditures, a fiscal deficit occurs. Economists (Friedman, 1998a; Kinney et al., 2002) point out that, in most circumstances, deficits are not the real issue. The real problem is whether it is cyclical or structural and how the government spends rather than how it levies. The increasing deficit is merely a symptom of the problem of over-spending. When governments are confronted by budget deficits, economists suggest that they must first determine whether the problem is cyclical or structural. Kinney *et al* (2002) points out that governments need to carefully consider three important factors when taking issues of balancing a budget: (i) cyclical versus structural deficits; (ii) the price of government and (iii) results to be achieved.

Cyclical deficits can be defined as short-term and caused by temporary economic downturns, whereas structural deficits are long-term and caused by long-term gaps between projected revenue growth and the estimated cost of government-funded services. The Twentieth Century Fund of the US gives a more universally recognised definition to deficits (Jondahl, 1996):

“There are two kinds of deficits – cyclical (or economic) and structural. A cyclical deficit occurs when a downturn in the economy results in slow or negative revenue growth and increased demands for state services in a given period.... A structural deficit exists when expenditures are greater than revenues even when the economy is not in recession or facing a cyclical downturn”.

In other words, “*Structural Deficit*” is that a deficit occurs even if the economy were operating at full employment (Edgmand, et al, 1996). The Canadian Centre for Policy Alternatives defines it that “*A structural deficit exists when government expenditure and revenues are such that, no matter where we are in the business cycle, the budget cannot be balanced*” (Klein, 2002).

To summarise the definitions, “*Structural Deficit*” refers to a period in which the economy is humming along at full employment, but revenues nevertheless fall short of expenditures (Miller, 2002a). On the other side of the token, a budget deficit occurs in an economic recession or in a cyclical downturn is by definition a “*Cyclical Deficit*”.

The different types of deficit are not mutually exclusive. Budget deficits may contain both cyclical and structural components (Kinney, 2002). Measures to stop these gaps include public service reductions, cost cutting, layoffs, tax increases, or some combination thereof. Kinney (2002) suggests if the estimated revenues are adequate to meet estimated expenditures over the long-term, governments can safely use reserves or other stop-gap measures to meet short term needs and remain fiscally sound. This is consistent with the view of the former financial secretary, Phillip Haddon-Cave, that a balanced-budget should be referred to an economic cycle rather than an annual basis. If the revenues are not expected to keep pace with expenditures, governments should make permanent, fundamental changes to their revenues, expenditures, or both. Once these changes have been

implemented, governments can use reserves to facilitate a more gradual transition to long-term solutions.

The price of government is that the amount which taxpayers are willing to pay to it in taxes, fees and charges from their income. Quantifying total revenue without pricing the government at the beginning of the budget process is a reversal of the usual budgetary approach. Governments ask the amount needed to fund budgetary costs without assessing taxpayers' satisfaction to their performance is hardly to gain the support of their people.

Most governments focus on the whereabouts of every dollar of public money but cannot show that they are delivering desired outcomes with public spending. Taxpayers felt justified in asking not only where the money goes, but also asking what the outcome has been achieved. Governments can effectively achieve the results by determining what the taxpayers want and then allocating the resources to produce the desired results, rather than raising taxes to meet their own spending needs. The government departments and agencies must then be held accountable for achieving those outcomes. Linking revenues to results is the essence of results-based budgeting, which is a dramatic departure from the traditional cost-based approach. Result-based budgeting shifts the focus from inputs (resources) to outcomes.

However, the cost-based budgeting approach remains in use in our budgetary system. The HKSAR Government failed to address the issues of "*the price of government*" and "*achieve the results*". Instead, it determined the deficits were structural despite evidence showing that they were not. Back to the deficits in the years after 1997, instead of reviewing the price of the Government and its achievements as suggested above, the HKSAR Government set up the Advisory Committee and the Task Force aiming at introducing new types of broad-based taxes to meet its overspending.

Before the *Task Force* released its final report in February 2002, the International Monetary Fund ("IMF") visited Hong Kong in January to conduct the 2002 IMF Article IV Consultation. The IMF later released its Staff Report on the HKSAR

which gave a positive assessment on Hong Kong's economic prospects and noted that the fiscal deficit in 2001/02 was mainly *cyclical*, which was consistent with the view of the former Financial Secretary in his speech 2002/03. The IMF report also commented that Hong Kong would be benefited from the increasing trade between Mainland China and the rest of the world after Mainland China's accession to the World Trade Organization ("WTO"). These were contradictory to the pessimistic conclusions submitted by the *Task Force* to the Financial Secretary in February 2002, just a month after the IMF's Staff Report, that "*Hong Kong is facing an ongoing and persistent fiscal problem*" and "*some of the economic forces leading to this situation are believed to be structural in nature*". For unknown reasons, the *Task Force* estimated the deficit would continue and reach \$55 billion in 2006/07 while the then Financial Secretary, Mr. Antony Leong, stated that the HKSAR would restore fiscal balance in the same year by the reduction of public expenditure in the press release on 16 May 2002. The contradictory views reflected that the *Task Force* either exaggerated the fiscal problems or exercised its traditional prudent estimation skill in the budget forecast, or both. It was likely a strategy for the Government to introduce the Goods and Services Tax (GST).

This can be further proven by looking at the comparison between the *Task Force*'s estimation of the operating deficits and actual results for the fiscal years 2001/02 to 2006/07 in Table 8:

Table 8: Comparison between Task Forces estimated operating deficits and the actual results

	Operating surplus/(deficit) (\$bn)	
	Task Force	Actual
2001/02	(50)	(47)
2002/03	(46)	(47)
2003/04	(43)	(29)
2004/05	(47)	(9)
2005/06	(50)	12
2006/07	(55)	39*
<i>Source: Census and Statistics Department and the Task Force's report; * Estimated in the Budget speech</i>		

This can be further proven by comparing the *Task Force's* estimated consolidated deficits with budgeted and actual results for the fiscal years 2001/02 to 2006/07:

Table 9: Comparison between Task Forces estimated consolidated budget and the actual results

	Consolidated surplus/(deficit) (\$bn)		
	Task Force's estimate	Budget	Actual result
2001/02	(66)	(3)	(63)
2002/03	(42)	(45)	(62)
2003/04	(55)	(68)	(40)
2004/05	(55)	(43)	21
2005/06	(54)	(11)	14
2006/07	(58)	6	55*

Source: Census and Statistics Department and the Task Force's report
**estimated in the Budget Speech.*

Table 9 shows that the *Task Force* over-estimated the Consolidated deficits for the years 2001/02 to 2006/07. Even though the actual government consolidated deficits were far lower than the Task Force's estimate (except for year 2002/03 due to the SARS outbreak), the Government set up an internal committee in 2004 to prepare the implementation of a GST in Hong Kong.

(ii) Is the tax base narrow?

Whether a tax system is broad or narrow dependent on how taxes are defined and the size of tax population, i.e. the portion of the population paying tax. The remarkable classic economist, David Ricardo defines "*Taxes were a portion of the produce of the land and labour of a country placed at that disposal of the government, and are always ultimately paid either from the capital or from the revenue of the country*". (Ricardo: 1817, P.105)

This definition is consistent with what Adam Smith defines, "*(Revenue) first, from some fund which peculiarly belongs to the sovereign or commonwealth, and which is independent of the revenue of the people; or secondly, from the revenue of the people*" (Smith, 1776: P.445). Thus, taxes include all revenues that the

government receives, regardless of whether it is called “tax” or otherwise. As we have seen, the HKSAR tax system has a good variety of taxes which charge a wide aspect of daily activities in addition to people’s income. There are a variety of invisible taxes charged on necessities, such as guarantee return on energies, infrastructures, high land premium and rentals.

The claim of our narrow tax system is based on two aspects (i) the territorial system (ii) the income-based tax system. For the territorial system, only those incomes derived from or arisen in Hong Kong are subject to tax. For income-based tax system, only taxpayers’ incomes are taxed.

Before 1996/97, Hong Kong had only 7 years financial deficits out of 50 years. All were temporary and recovered in the immediate following year except for the fiscal years 1982/83 and 1983/84. They were of cyclical nature and were consistent with Haddon-Cave’s budget objective that a balanced budget does not mean on an annual basis, it means in an economic cycle. It seems both the territorial system and the income-based system ran well in the 50 years.

However, there have been 5 years of deficits since the handover in 1997. The claim of “narrow tax base” and “structural deficit” came into the picture. It was due to the significant tax cuts and increase in spending. During the 1990s, the exemption items were increased, tax rates were decreased, tax bands were eased and allowances were raised. The most obvious examples are that the marginal tax rates fell from 25% in 1991 to 17% in 1998; and personal allowance increased from HK\$41,000 in 1991 to HK\$108,000 in 1998.

When tax exemptions are expanded, one consequence is that a large number of individuals drop out from the tax net, especially at times of recession when their income falls. This happened in Hong Kong after 1997 when people’s incomes fell after the Asian Financial Crisis in 1998 and the global recession of the bursting economy in 2000. The tax structure was said to be unstable, and its base was said to be narrow. Low-income earners fell outside the tax net; High income earners reduced. People’s income fell, unemployment rose, the demand for government welfare expenditure went up. The increasing reliance on high income earners can

be seen from Table 5(a) (p.57) and 5(b) (p.58) of this project.

Table 10 depicts the picture that the expansion in personal allowance and tax bands caused a large number of individuals to fall outside the tax net; the effect became obvious in 1998, when people's income started to fall. The total revenue from individual tax (salaries tax, property tax and personal assessment) fell. The freeze of government's charges and fees also caused the revenue decrease.

Table 10: The changes of tax allowances, tax bands and Marginal rates

Fiscal year	GDP at current price (HK\$m)	Revenue/ GDP%	Revenue (HK\$ m)	Growth	Percentage of various tax on revenue					Tax band	Marginal Rates	
					Profits tax	PA	Property Tax	Salaries Tax	Personal Allowance/ additional allowance			
1989/90	549,474	15.0%	82,430.2	13.4	25.8	1.1	1.2	12.7	32,000/7,000	10,000	3,6,9,12,15,18,21,25	15/16.5
1990/91	617,511	14.5%	89,523.8	8.6	23.7	0.9	1.3	14.6	32,000/7,000	10,000	2,4,9,12,15,18,21,25	15/16.5
1991/92	718,242	16.0%	114,699.9	28.1	22.0	0.9	1.1	15.2	34,000/7,000	20,000	2,9,17,25	15/16.5
1992/93	834,253	16.2%	135,310.9	18.0	23.8	1.0	1.0	14.9	39,000/7,000	20,000	2,9,17,25	15/17.5
1993/94	959,361	17.4%	166,601.4	23.1	23.9	0.9	0.9	13.5	49,000/7,000	20,000/30,000	2,9,17,25	15/17.5
1994/95	1,065,241	16.4%	174,998.6	5.0	27.1	1.0	0.8	13.5	65,000/7,000	20,000/30,000	2,9,17,20	15/16.5
1995/96*	1,135,560	15.9%	180,045.1	2.9	25.9	1.6	0.9	14.6	72,000/7,000	20,000/30,000	2,9,17,20	15/16.5
1996/97	1,263,907	16.5%	208,358.0	15.7	24	1.7	0.9	13.8	83,000/7,000	20,000/30,000	2,9,17,20	15/16.5
1997/98	1,365,669	20.6%	281,226.0	35.0	19.7	1.6	0.6	10.7	100,000/0	30,000	2,8,14,20	15/16.5
1998/99*	1,274,964	17.0%	216,115	-23.2	20.9	1.9	0.6	11.6	108,000	35,000	2,7,12,17	15/16
1999/2000	1,286,100	18.1%	232,995.0	7.8	16.2	1.4	0.5	10.7	108,000	35,000	2,7,12,17	15/16
2000/01*	1,314,480	17.1%	225,060.3	-3.4	19.1	1.5	0.5	11.7	108,000	35,000	2,7,12,17	15/16
2001/02*	1,287,343	13.6%	175,559.8	-22.0	25.3	2.1	0.6	16.3	108,000	35,000	2,7,12,17	15/16
2002/03*	1,273,581	13.9%	177,489.0	1.1	21.9	1.9	0.7	16.8	108,000	35,000	2,7,12,17	15/16
2003/04*	1,241,313	16.7%	207,338	16.8	23.5	1.3	0.5	13.5	104,000	32,500	2,7,5,13,18,5	15.5/17.5
2004/05	1,305,917	20.2%	263,591	27.1	22.2	1.1	0.4	12.9	100,000	30,000	2,8,14,20	16/17.5
2005/06	1,408,115	17.5%	247,035	-6.3	28.3	1.3	0.5	15.2	100,000	30,000	2,8,14,20	16/17.5
<p><i>The additional tax is subject to a 10% claw-back in years 1987/88 to 1989/90 such that when a person's income reaches \$84,000 (1987/88), \$106,000(1988/89), \$109,000 (1989/90) and a married couple's combined income reaches \$170,000 (1987/88), \$214,000(1988/89), \$220,000(1989/90); the respective additional allowances will be reduced to nil. The additional allowance was combined with basic allowance from year of assessment 1998/99.)</i></p>												

The “sale” of government land is a tax itself but is of a hidden nature. The word “sale” is somewhat misleading. All land in Hong Kong belongs to the Government and is sold by a medium “lease” term to a maximum lease term up to year 2047 in accordance with the Basic Law. Apart from the hidden tax in the high land price, there are a number of hidden taxes in our daily consumptions and necessities in various forms owing to the government policy of licensing public service to the licensees with a minimum guarantee of return on assets. For instance, the guarantee return on assets policies for tunnel investors, electricity companies, transportation systems, etc. People pay the hidden tax through their daily consumption, directly or indirectly, since the “tax” is embedded in the costs of the goods and services they consume. In substance, all Hong Kong residents are subject to tax. This “broad-based” hidden tax system explains the reasons that deficits occurred only 12 times in the past 60 years and the deficits were merely caused by cyclical economic frustrations.

(iii) GST: International trend?

One of the arguments for the need of implementing a GST is that all other developed countries have a GST. Hong Kong is one of the few developed economies that do not have a GST. This argument is hardly a good one even if it is not invalid. First of all, the USA has no GST. Even though there have been some discussions over there, the concern of the adverse impact on the economy is dominant. Secondly, every economy has its unique feature. The simple tax regime is one of the economic features that make Hong Kong grow faster than those with a complicated tax regime. It has gained numerous praises from a number of renowned economists, such as Milton Friedman, Ronald Coase, etc. Thirdly, Hong Kong has lower government spending than those with a GST. For instance, Hong Kong does not have a national defence burden. Fourthly, most countries use a GST to replace other taxes. For instance, Canada used the GST to replace Federal Sales Tax; Australia used it to replace the Whole Sales Tax; New Zealand, Singapore and some European countries used a GST to compensate a cut in income tax, etc. However, the proposed GST will only be an additional tax in the tax system. The Government expressed that there would be a tax cut but it had not made it a firm policy. Finally, Hong Kong does not have huge national debts as

those countries having a GST. In Canada, it was the cut of government spending by the Liberal government that killed the deficits rather than the implementation of the GST in the 1990s. All in all, the tax structure depends on one's specific economic feature. International trend should not be a factor to implement a new tax.

(b) Reasons of objection to the GST

About 2,400 submissions were received for the Tax Reform Consultation. The report was released in June 2007 showing that the public objected to the GST. The GST supporters defended that the general population was ignorant as to the future challenges of the economy.

The major public concerns were: (i) the GST would complicate the simple tax system which had been praised as one of the key factors of Hong Kong's success; (ii) the consumption tax would dampen consumption and undermine Hong Kong's competitiveness.

In addition, there were three broad lines of the objections against the GST (i) the tax base was not narrow and the deficiency in the financial system was not structural, (ii) the GST was an unfair tax, and (iii) the Government would overspend (as a means of increasing the size of the government sector). (i) and (ii) have been dealt with in previous sections. The perceived government over-spending is the main issue that the public objected to the GST. It has been proven in other economies that the GST provides an easy source of revenue, making governments less conscientious in controlling their spending. Mitchell (2009) gives a good account for how the VAT would increase government spending by extracting the OECD's data:

“VATs are associated with both higher overall tax burdens and more government spending. In 1965, before the VAT swept across Europe, the average tax burden for advanced European economies (the EU-15) was 27.7% of economic output, roughly comparable to the U.S., where taxes were 24.7% of GDP, according to data from the Organization for Economic Cooperation and Development OECD).

European nations began to impose VATs in the late 1960s, and now the European Union requires all members to have a VAT of at least 15%.

Results? By 2006, the OECD reports that the average tax burden for EU-15 nations had climbed to 39.8% of GDP. The tax burden also has increased in the U.S., but at a much slower rate, rising to 28% for that year.”

Mitchell (2009) analysed the data for government spending of the EU and the USA:

“The spending side of the fiscal equation is equally dismal. In 1965, according to European Commission figures, government spending in EU-15 nations averaged 30.1% of GDP, not much higher than the 28.3% of economic output consumed by U.S. government spending. According to 2007 data, government spending now consumes 47.1% of GDP in the EU-15, significantly higher than the 35.3% burden of government in the U.S.”

Many researchers found that government spending had an adverse impact on economic growth because of the taxes that were imposed to finance the budget (Mitchell, 2005).

Riedl (2008) used the examples of tax rebate, spending in infrastructures and states bailouts to explain why government spending did not stimulate economic growth.

The full incidence of a tax depends not only on the tax but on how the public money is spent. Even though the Government promises not to abuse the revenue, taxpayers are not confident in the Government for its promises. Years ago, when the Government proposed to introduce unleaded gasoline, it impressed taxpayers that the price of unleaded gasoline would be lower than the lead gasoline by HK\$1. When people were hoping that the unleaded gasoline would be set at a price one dollar lower than they used to pay for lead gasoline, the Government simply increased HK\$1 of the lead oil. Consumers found they were cheated. Among other things, the Government cried for cutting government spending on the one hand, it spent HK\$5.2 billion to build a new central government building without giving sufficient explanation on the high cost on the other hand. All these indicate the size of Government is increasing. The Government is overspending public money.

5.4 CONCLUSIONS

To conclude, the financial deficits occurred after the handover were largely due to the increase in government intervention which reduced the scope of free market mechanism, even though the Asia Financial Crisis and SARS outbreak worsened the deficits. The intervention measures benefited a handful of wealthy and powerful tycoons rather than the general public. As a result, the income gap was widened. Besides the abandonment of the long adopted positive non-intervention policy, the budgeting approach was not as prudent as before. The government expenditure rose over 20%, diminished the size of the private sector and increased the size of Government. Armey curve equation indicates that the optimal government spending should be kept not more than 18% of the GDP. The Government's claim that the deficits were structural and our tax base was too narrow was not likely to be substantiated. The fast recovery from the deficits in less than three years' time has proven that the fiscal deficits were cyclical. The tax system has covered most residents in Hong Kong through the indirect tax system. In other words, some taxes took an invisible form hidden in the land price, utility and transportation costs. The narrowing taxing population was due to the tax cut and the government over-spending. All these form a valuable basis for analyzing the need for a GST in Hong Kong.

The reasons claimed by the Government for implementing a GST in Hong Kong are found unconvincing. It is evident in other countries that a GST is likely to increase the cash economy and cause government over-spending. The benefits of increasing the public revenue are likely offset by the increase in public expenditure (see Chapter 2 Section 2.3(b)).

CHAPTER 6

SURVEY FINDINGS AND ANALYSIS

6.1 THE FINDINGS AND ANALYSIS OF THE RESULTS OF QUESTIONNAIRE

327 responses were received and 17 were not taken as valid since the respondents did not put their membership number on the returned questionnaires. Among the respondents, 280 were HKICPA members, 12 were CGA members, 7 were ACCA members, 6 were CPA-Australia members, 2 ICAEW members, 1 AIA member, 1 CMA member and 1 CIMA member. The number of responses from the HKICPA members is substantial. Therefore, the chance for duplicated responses was not high.

(a) Questions 1 and 2: (Background information)

Among 310 valid responses, 95 (30.6%) replies from practising accountants, 207 (66.8%) from non-practising accountants and 8 (2.6%) from retired/unemployed accountants were received. 145(46.8%) of the respondents had lived in a country with GST/VAT against 160 (51.6%) that had never done so. 5 (1.6%) respondents did not respond to this question even though they gave their membership information. This background information provides us with a better analysis of the views of different groups of accountants on the tax system and the GST. The responses to Questions 1 and 2 are shown in Figures 1 and 2 respectively.

Figure 1: *Participants of different groups of accountants*

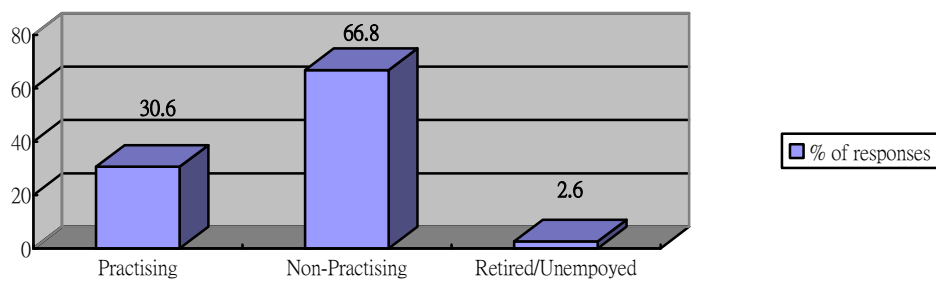
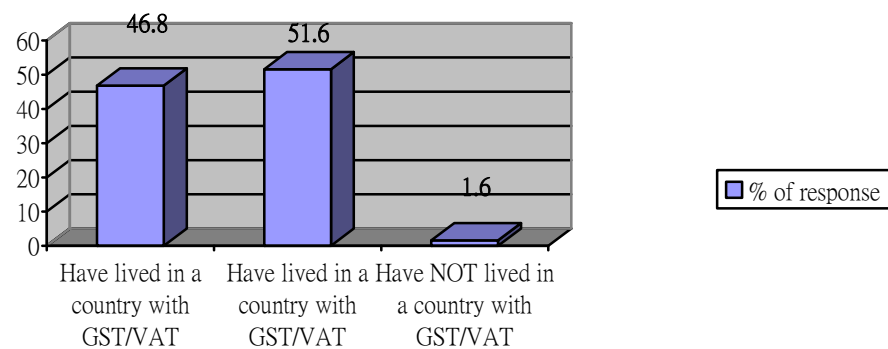


Figure 2: *Distribution of participants who have/have not lived in a country with GST/VAT.*



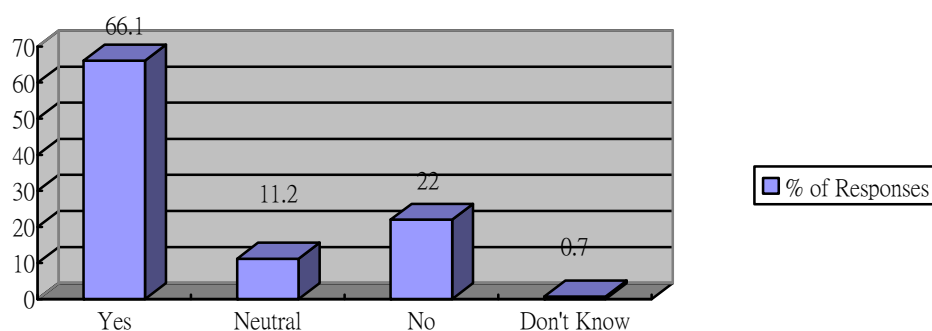
The ratio of practising and non-practising accountants in the HKICPA's record is about 15: 85. The percentage of responses from practising accountants is higher than this ratio. The result shows that accountants in public practice are more concerned about the GST than those accountants not in public practice.

(b) Questions 3 to 7 (the HKSAR's tax system)

Question 3: *Do you agree that there is a fundamental structural problem in the tax system?*

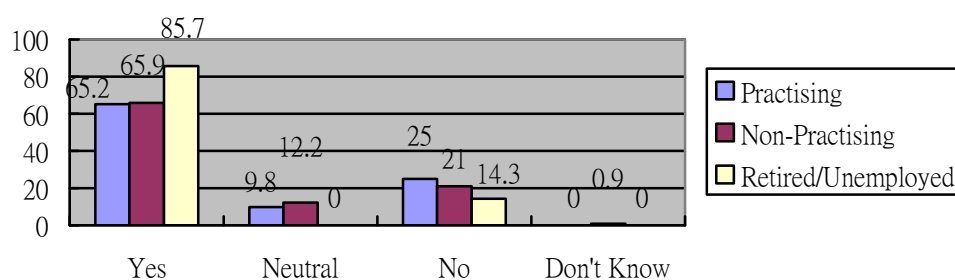
66.1% of the respondents agree that there is a fundamental structural problem in the tax system. 22.0% disagree, and 11.9% are either neutral or of no idea. The result is summarised in Figure 3(a) below.

Figure 3(a): *Distribution of responses to whether there is a fundamental structural problem in the tax system.*



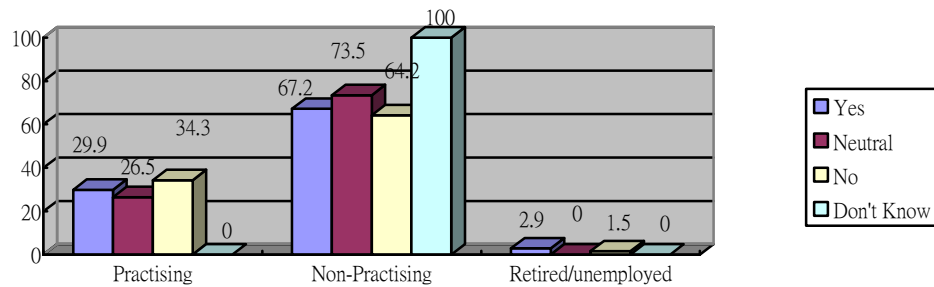
The results of Figure 3(b) show the proportion of each response in the different groups of accountants towards the GST. The views of practising and non-practising accountants are quite similar.

Figure 3(b): *Responses from different groups of accountants towards the fundamental structural problem in the tax system.*



The results in Figure 3(c) indicate the proportions of different groups of accountant in each response.

Figure 3(c): Comparison of different groups of accountants in each reply.



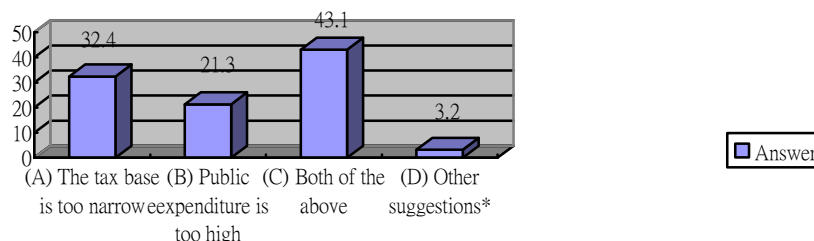
From the findings of the literature analysis, the deficits were cyclical, not structural. This survey result seems not consistent with the literatures and analysis of the tax system. However, this is not surprising since the Government has been “*propagandizing*” the “*structural*” problem in our tax system and emphasizing the small taxing population for many years. This result reflects that some accountants have been influenced by the Government and the media that the tax system issue is structural. They may not alert the “hidden” taxes in the economy.

Question 4: *If (yes) to No. 3, which of the following is the major cause of the structural problem?*

43.1% of the respondents opine that both the narrow tax base and high public expenditure are the major cause of the fundamental structural problem in Hong Kong’s public finances. 32.4% and 21.3% believe narrow tax base and the high public expenditure are the major cause respectively.

In general, respondents believe the causes are: (i) misallocation of public resources, (ii) poor government performance and (iii) uneven income distribution etc. The results are summarised in Figure 4.

Figure 4: *The major cause of the fundamental structural problem in the public finance.*

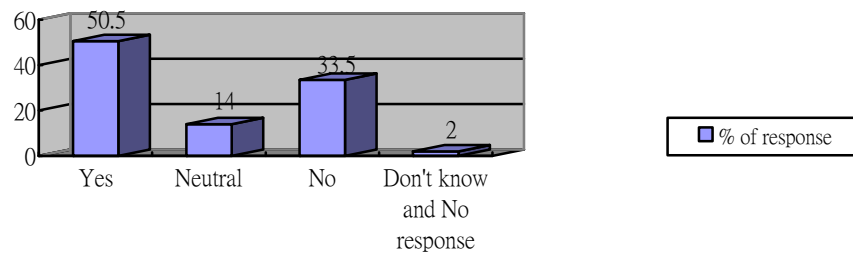


The result is consistent with the analysis in Question 3 that the majority of respondents hold the view that the narrow tax base is the main cause of the structural problem in the tax system. 32.4% of the respondents believe the narrow tax base alone causes the public finance structural problem and 43.1% believe both the narrow tax base and high government expenditure are the major cause of the problem. In other words, a total of 75.5% of the accountants believe that the structural problem is arisen from the narrow tax base. 64.4% of the respondents find that high government expenditure is one of the factors contributed to the structural issue. This is consistent with the literal analysis that the Government expenditure has to be lowered.

Question 5: *If (yes) to No. 3, is it necessary to introduce a new tax to solve the problem?*

Among those 66.1%, who agree that there is a fundamental structural problem in the public finance system, 50.5% hold the view that a new tax is required. 14.9% of these 50.5% of the respondents do not agree to implement a GST as shown in their responses to Question 8 of the questionnaire (see below). Their views are summarised in Figure 5.

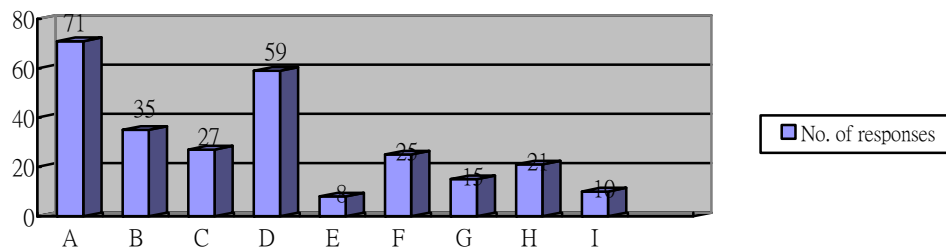
Figure 5: Response to the need of a new tax



Question 6: *If there were a need to broaden our tax base, what would be the order of preference of the following (1=most preferred; 10=least preferred) (apply each digit once)*

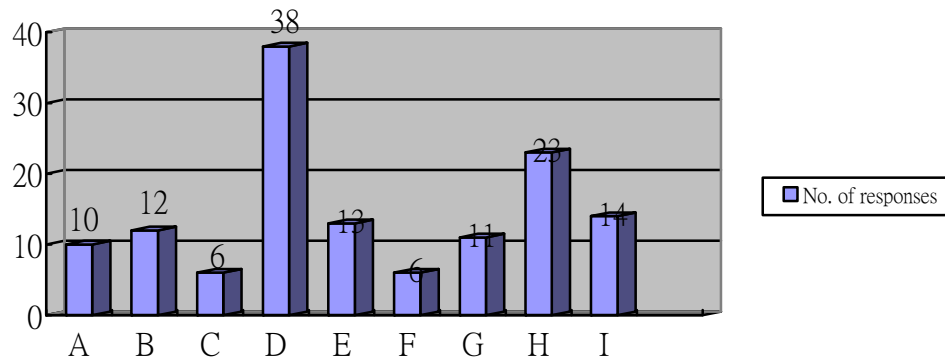
Not all respondents listed all the preferences in this question. Some treated the order of preferences as scores and gave the same number more than once. Even though the answers are not expected as the original design, it would not affect the results when using the responses as scores. Set aside option 10 (the other suggestions) for the time being, Figure 6 shows the Progressive Profits Tax Rate got 71 responses as the most preferred among all. GST received 59 and was ranked the second most preferred. Sales tax only obtained 8 as the option for the most preferred.

Figure 6(a): Responses to most preferred option



When looking at the least preferred, GST received 38 responses, “Reduce Personal Allowance” received 23; “Change the tax base” received 14, while Sales Tax received 13. The fewest responses received was Land Appreciation Tax.

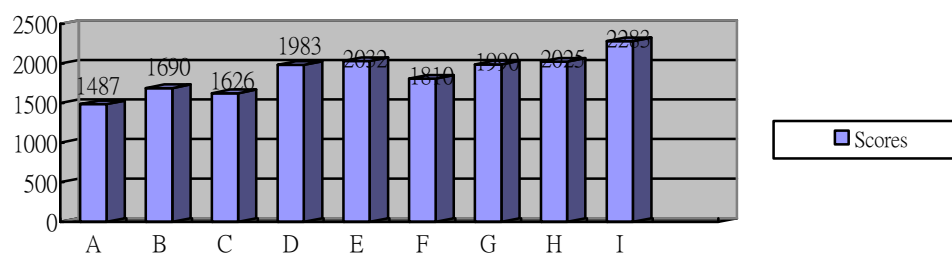
Figure 6(b): Responses to least preferred option



The contrast between Sales tax and the GST indicates that accountants generally understand the difference between sales tax and GST, i.e. the former only charges sale of goods while latter taxes goods and services. The results are interesting. GST is the second most response being selected as the most preferred tax but it also scores the highest number being selected as the least preferred tax. The view among accountants is divided. When analyzing it together with question 4, which asks participants to comment whether the tax base is narrow. 37 respondents selects GST as the most preferred tax opines that the tax base is narrow while 27 selecting “Progressive Profits tax rate” find the tax base is narrow. It indicates accountants agree that a GST is a viable solution for a narrow based tax.

If one selected more than one option but leaving the other options unselected, all the unselected options are assumed the least preferred and assigned a score of “10”. Under this assumption, the lowest score option means the most preferred while the highest score option represents the least preferred. The resulting scores are shown in Figure 6(c). The order of preference is as follows:

Figure 6(c): Scores for each option



Types of tax	Scores	Order of Preference (scores)
Progressive Profits Tax Rate	1,487	1
Land Appreciation Tax	1,626	2
Capital Gains Tax	1,690	3
Green Tax	1,810	4
Goods and Services Tax (GST)	1,983	5
Wealth Tax	1,990	6
Sales Tax	2,032	7
Reduce Personal Allowance	2,025	8
Change the tax base to residency	2,283	9

55 respondents gave suggestions. 28 of these respondents selected all 10 options in the questionnaire, slightly more than half. It indicates that respondents having better alternatives in mind was likely reluctant to rank the preference. The suggestions are summarised as follows:

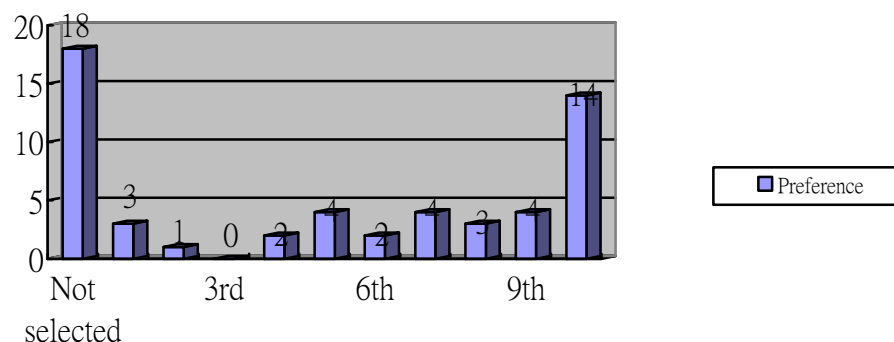
Figure 6(d): Other suggestions

	Suggestions	Number of responses
	No need to change the tax system	15
	Higher tax/duty on commodities (tobacco, luxury goods).	12
	Control public expenses	7
	Improve the return on government investments	5
	Arrival/Departure tax	3
	Estate Duty	3
	Increase government rent and rates	2
	Dividend tax	2
	The suggestion is not clear	2
	Gift tax	1
	Airport improvement tax	1
	Measures to help people earn higher income	1
	Privatise government services	1
	Options 1 to 6 but not GST	1
	Need more information	1
Total		57

Among the 57 responses, 15 opined that there was no need to change the tax system. 12 suggested increasing or adding tax on gambling and commodities such as tobacco, luxury goods, wine etc. 7 urged the government to control the public expenditures 5 urged the government to improve its investment.

	Respondents who gave comments	Number of responses
	Did not select GST	18
	Selected GST as the least preferred option	14
	Selected GST as the 9th preferred option	4
	Select GST as the 7th preferred option	4
	Selected GST as the 5th preferred option	4
	Selected GST as the most preferred option	3
	Selected GST as the 8th preferred option	3
	Selected GST as the 6th preferred option	2
	Selected GST as the 4th preferred option	2
	Selected GST as the 2nd preferred option	1
Total		55

Figure 6(e): Respondents who gave comments and ranked GST in the following preference

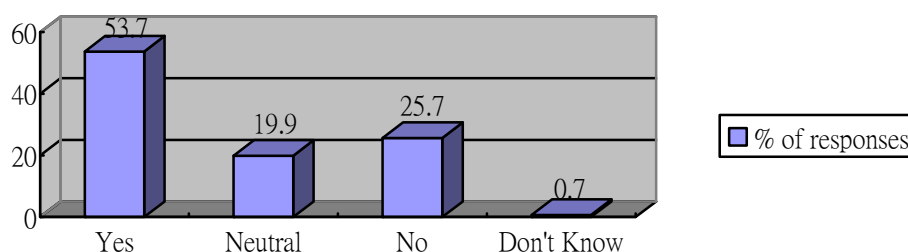


Question 7: *Do you think we need a comprehensive review of the current tax system?*

53.7% of the respondents shared the view that a comprehensive review of the current tax system was needed while 25.7% held the contrary view, 20.6% were of neutral view or have no idea. Figure 7(a) shows the responses.

This is consistent with the view that accountants believe the tax system has a structural system and the tax base is narrow.

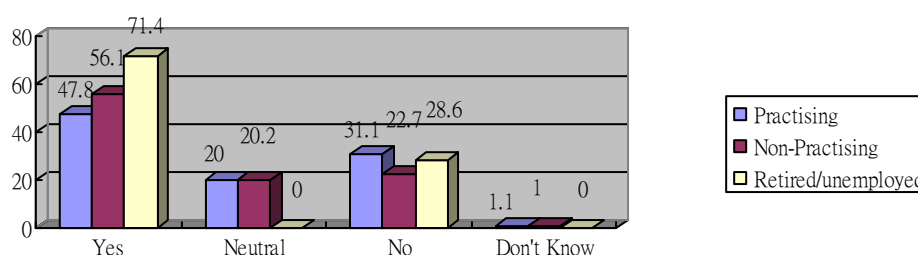
Figure 7(a): Proportion of each response to the need for a comprehensive review of the tax system



The results in Figure 7(b) show that the practising accountants had slightly more divided views on the need for a comprehensive tax review than the non-practising

accountants. Compared with practising accountants, non-practising accountants tend to believe more in the need for a comprehensive tax review.

Figure 7(b): *Analysis of the proportion of each response to the need of a comprehensive tax review in the different groups of accountants*



Taking Questions 3 to 7 together for analysis, the responses of the questions suggested that most of the accountants believed the tax system had a structural problem. Question 3 alone did not give us sufficient information. Questions 4 and 5 were the extension of Question 3 for those who responded that a structural problem existed in the tax system. It is worth noting that only 32.4% of the accountants supported that the narrow tax base was the main and sole cause of the structural problem. A majority of respondents held the view that the high government expenditure and the narrow tax base together were accounted for this problem. It reflects that the lengthy propaganda of the narrow tax base had some effect on accountants, but the high government expenditure still concerned them the most. The result of Question 5 suggests that only slightly more than a half of the respondents, who believed a structural problem existed, agreed with a need for a new tax, but it might not be the GST. It indicates that the respondents preferred other options. Question 6 strengthens this view that, if a new tax was needed, the respondents preferred those taxes of progressive or proportional nature to those of regressive nature. Progressive profits tax, capital gains tax and land appreciation

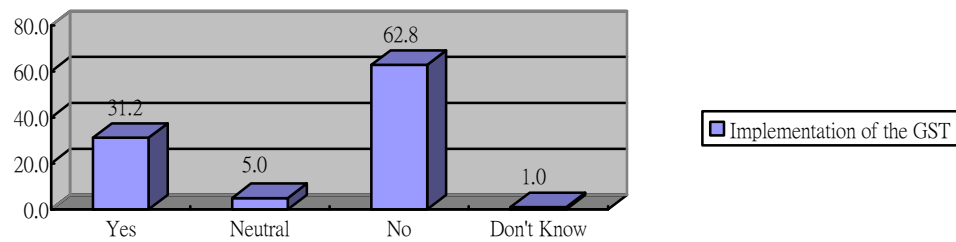
tax are of progressive and proportional nature, and are based on the “Ability-to-pay” principle (see Chapter 4), which is regarded “fairer” than those of regressive nature. The GST and green tax are not charged in respect to the level of income, thus their regressive nature makes them less preferable. Another explanation to the low ranking of green tax is that the respondents did not find green taxes a solution to the structural problem. The responses of Question 7 show that not all accountants who agreed that we had a fundamental structure problem agreed to have a comprehensive tax review. It might be explained that they did not see the need or they were worried about the change would add burdens to their practice. However, a more likely explanation is that some accountants saw that the problem was not caused by the tax system, but by the government expenditure. This explanation is consistent with the result of question 5.

(c) Questions 8 to 12 (The GST)

Question 8: *Do you agree to implement GST?*

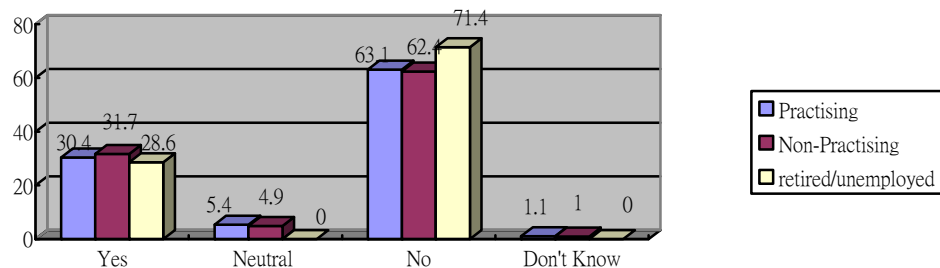
This question asked the respondents directly about the implementation of GST. The result shows that 62.8 % of the respondents did not agree to the implementation of the GST, while 31.2% of the respondents agreed to the implementation of the GST. The results are summarised in Figure 8.

Figure 8(a): *Distribution of responses to the implementation of the GST*



Among the opponents, the results of Figure 8(b) suggest that most respondents opined that the GST was an unfair and regressive tax. These findings are consistent with our previous analysis in Chapter 5. The high government expenditure is one of the respondents' major concerns. The expenditure should be lowered first before considering a new tax.

Figure 8(b): *The proportion of each response to Q8 in the different groups of accountants*



The responses highly suggested that the GST was not wanted. It strengthens the analysis in Question 6 that accountants prefer, if really needed, a tax of progressive or proportional nature to of regressive nature and an income-based tax is preferred to a consumption-based one.

80 respondents gave reasons on their options. Some expressed more than one reason. Overall, the opponents of the GST were more eager to give reasons than the supporters. The reasons of their options are summarised as follows:

Support GST		Do not support GST	
<i>Reason</i>	<i>No of responses</i>	<i>Reason</i>	<i>No. of responses</i>
Fair basis, user pays principle	4	Degrade the simple tax system	9
Broaden the tax base	9	Administrative cost is high	15
		Reduce public expenditure first	17
		It is regressive by nature, not fair to the poor and widens wealth gap	20
		Adverse impact on the economy, tourism and business environment.	23

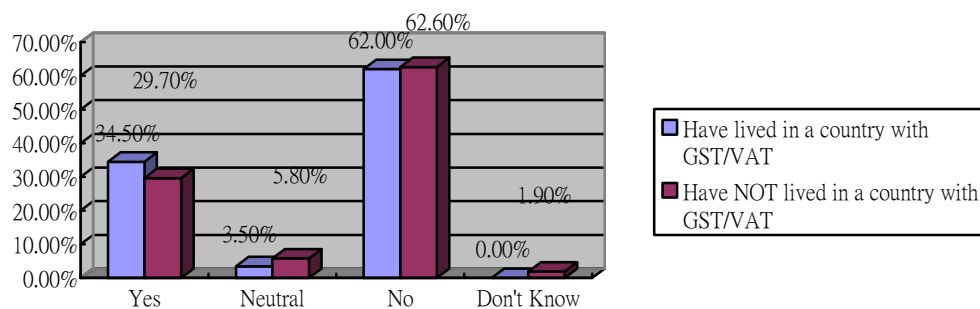
The findings are consistent with our previous literature review, i.e. accountants expected that the GST would have an adverse impact on the economy due to its regressive nature which might widen the wealth gap of people. In addition, the respondents had few concerns, one was that the GST would complicate the simple tax system and the other was the size of the Government was large. Supporters of the GST were of the view that the GST was on a fair basis and would broaden the tax base.

The views of different groups of respondents are shown in Figure 8(b). 63.1% of the responding practising accountants objected to implementing GST, slightly higher than that of non-practising accountants, i.e. 62.4%. The result does not show that practising accountants particularly support GST – contrary to what the media had made out. It suggests that accountants realised that they would also suffer from the deterioration of the economy even though the GST was said to benefit the practising accountants for more reporting and consultation business. The disadvantages to the economy outweighed their personal benefits, if any.

The difference between the views of those who have lived and those who have never lived in a country with GST/VAT is small and the results are shown in

Figure 8(c). Among those who had lived in a country with GST, 62.0% were against GST and 34.5% were for GST as compared to 62.4% against and 29.7% for in the group who had not. This suggests that accountants knew the impact of GST regardless of whether they had the experience of living with it or not. The responses reflect that accountants are knowledgeable to the tax and its impact on the economy, regardless of whether they have experienced in it.

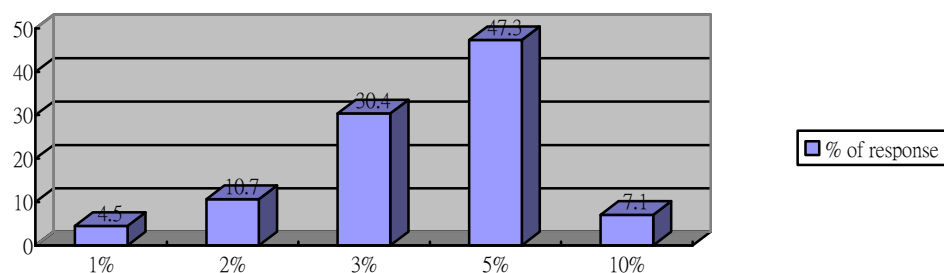
Figure 8(c): *The proportion of each response to Q.8 in the group who have lived in a country with GST/VAT and the group who have not.*



Question 9: *If you agree to implement GST, what tax rate do you think is appropriate?*

If the GST *were* introduced, 47.3% of the respondents suggested a rate of 5% while 30.4% suggested 3%. 4.5%, 10.7% and 7.1% suggested tax rates of 1%, 2% and 10% respectively. The results are summarised in Figure 9. It suggests that responding accountants realised that the administrative cost would be higher and the GST could only be effective, or balance, at tax rates between 3% and 5%.

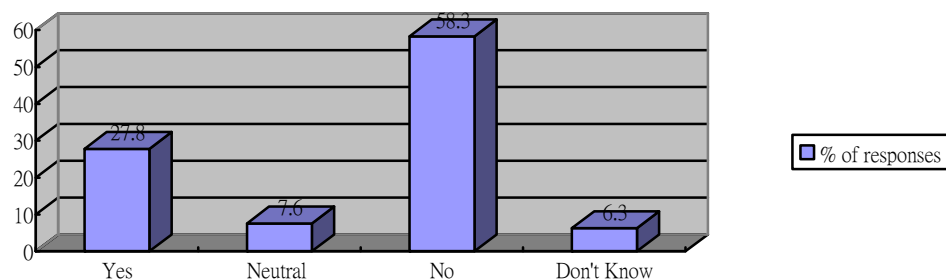
Figure 9: *Responses to the GST rate*



Question 10: *Do you expect the introduction of GST to be revenue-neutral, i.e. that the Government will not generate additional tax revenue?*

The result in response to the HKSAR Government's revenue-neutral claim is shown in Figure 10 – 58.3% of the responding accountants did not believe it, and only 27.8% did believe it. It reflects that respondents realised that the new tax was not for stabilising public revenue, but to increase it. It seems not convincing that the GST was revenue neutral purpose.

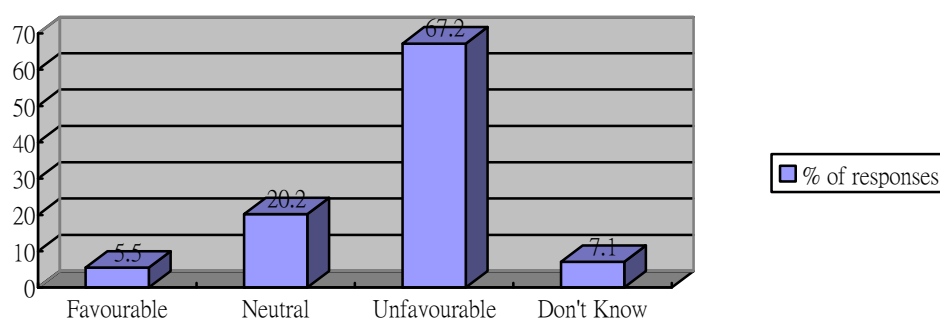
Figure 10: *Responses to whether the GST is revenue-neutral*



Question 11: *If GST is set at 5%, what will the impact be on the Hong Kong economy?*

A majority (67.2%) of respondents expected the impact of the GST on the Hong Kong economy to be unfavourable while only 5.5% regarded it to be favourable. This casts doubt on the Government's claim that GST would ensure Hong Kong's prosperity. The result is shown in Figure 11. Responding accountants did not believe a new tax would help the economy. It seems contradictory to the responses in Question 5 that respondents agreed to a new tax. However, if we look at the responses from Questions 4 to 7 as a whole, we would find that respondents preferred the reduction of Government expenditure to a new tax. This is consistent with the views of free economists as we saw in previous chapters.

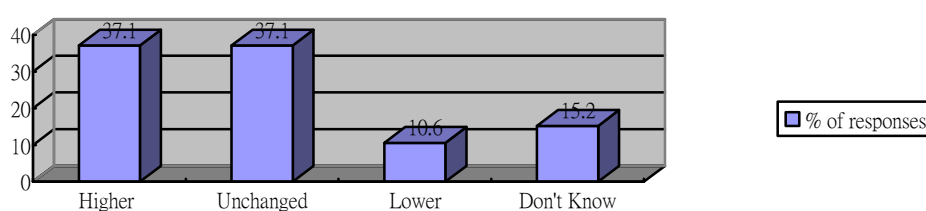
Figure 11: *The Impact of GST at 5% on the Hong Kong economy*



Question 12: *If the GST is implemented, what do you expect the rate to be in five years' time?*

Even though the Government proposed that the rate of the GST would be set at 5% for 5 years, 37.1% of the respondents expected that the rate would be increased within 5 years while the same proportion of respondents (37.1%) expected it to remain unchanged. It reflects that responding accountants regard the GST rate has to be at least 5% to balance the administrative cost.

Figure 12: *Expected changes in the GST rate in five years' time*



Question 13 is an open-ended question. 154 respondents gave their comments. As in the case of Question 8, the supporters of the GST were not as eager to express their views as the opponents. Among the comments, 76% and 24% of the responses were given by the opponents and supporters respectively. The majority views of the supporting side claimed that GST was fair, broad based and needed. However, 54% of the 24% supporting comments reserved the view that the Government should ensure the control of expenditure, granted exemptions for

necessities and considered taxing luxury goods first. Among the opposite views, they mainly opined that GST would be at the expense of the poor, damage the economy, incur unjustifiable costs (compared with the benefits), and render public expenditure uncontrollable.

CHAPTER 7

CONCLUSIONS AND RECOMMENDATIONS

7.1 CONCLUSIONS

This project analysed the economy, economic policies and financial policies of Hong Kong and the GST. On the basis of the documentary and literature analysis and the survey results, we may draw the following conclusions:

- (1) In Chapter 2, results of the literature review found that Hong Kong had had a sound economy and exercised free economic policies before 1997 but its economy became vulnerable after the handover largely due to the change of economic and financial policies. Hong Kong possesses a number of key elements of success. The deficits after 1997 were of cyclical nature, not of structural since the surplus was restored when the economy recovered. The deficits were largely caused by the unprecedented economic blows (Asian financial crisis, bursting economic bubble and SARS outbreak), changes of economic policies, (the abandon of positive non-intervention policy and the trends to depart from the fiscal prudence policy) and increase in government expenditure. The governmental intervention has been increasing since the handover of the sovereignty. The positive non-intervention policy, which is based on the principles of free economy, has been gradually abandoned after the restoration of sovereignty. The income gap is widened because the economy is heavily reliant on financial services, which could not sufficiently support a population of seven-million. Moreover, under the current political system, the HKSAR Government and rent-seekers only focus on arriving at a political agreement on their pursued outcomes rather than pricing the government in the budget process. The accountability to taxpayers and electorates is of little concern to them. Thus, the government spending increases. Together with the flawed political system, all these factors have turned the economy more vulnerable than ever before. The transformation

and the increase in government intervention widen the income and wealth gap. The high government expenditure worsened the deficit in the years between 1998 to 2003. The tax base is not narrow since there are numerous “hidden” tax imposed on our daily life, either directly or indirectly. The tax base is broad enough to make surpluses in most of the financial years, except for the years having cyclical deficits in times of economic downturn.

- (2) Chapter 3 also concludes that the GST is a tax of regressive nature. It widens the income and wealth gap. Its advantages of stabilising the tax revenue would be offset by the decrease in other income taxes due to the increase in cash economy and decrease in investments. It will cause government over-spending.
- (3) On the basis of the survey results, the following conclusions could be drawn:

(A) Tax System

- (a) A majority of the respondents agreed that the public finance system had a fundamental structural problem. The problem was caused by either high public expenditure or the narrow tax base or both.
- (b) About half of the respondents, who agreed that a fundamental structural problem existed, suggested that a new tax was needed but that the tax was not necessarily a GST. Accountants preferred taxes with either an income-based or wealth-based nature to a general consumption tax.
- (c) A majority of respondents suggested a comprehensive review of the tax system even though practising accountants seemed to have reservation on this.

(B) Goods and Services Tax

- (a) 62.8% of the respondents are opposed to the GST. The views of practising and non-practising accountants were close to each other. Whether the respondents had lived in a country with GST/VAT did not make a difference.
- (b) The GST supporters felt that the GST was fair, broad-based, and consistent with the user-pays principle. The GST opponents expressed their concerns on the high administrative costs, unfairness to the poor, widening of the income distribution gap, impact on the business environment, tourism and consumption, weakening of Hong Kong's competitiveness, and deterioration of the simple tax system.
- (c) If the GST were implemented, respondents believed that the tax rate should be set at 3% to 5%. A majority of respondents did not believe that the GST would be revenue-neutral. This indicates that they were not confident that the increase in revenue from the GST would be totally offset by the reductions in income tax and the increase of transfers to help the poor.

7.2 RECOMMENDATIONS

This project aims to provide policy makers with a reference for analysing the need of a GST or a tax reform in Hong Kong. The results of the survey and analysis should give some thoughts to policy makers in respect of the GST. All parties who are interested in taxation or hold the view that Hong Kong requires a tax reform may find this report useful.

Even though the results of the survey are consistent with the responses to the Consultation of the GST appealed by the HKSAR Government and the results of

the survey conducted by the HKICPA, the low response rate remains an argument against its representation. I would recommend that further studies on the views of accountants towards a GST in other countries having implemented a GST or other similar consumption tax and its impact on the accounting profession should be conducted. This would enrich our knowledge of the tax and the view of fellow accountants regardless of their residence.

In addition to carrying out more studies on the GST, the following would be recommended:

- (1) The HKSAR Government should review its spending and control it;
- (2) Measures should be taken to reduce the income and wealth gap;
- (3) Retain the positive non-intervention financial policy and fiscal prudent policy.
- (4) While reviewing the tax system, the simple tax system should be maintained.

7.3 IMPACTS OF THIS PROJECT

(a) On the GST in Hong Kong

The results of this report were publicly announced in a media conference on 17 September 2006. Almost all the media covered the report. This report aroused more debates and surveys carried out afterwards. The HKICPA conducted a survey on the GST and found that 59% of around 2,000 respondents were against the GST. The Government had announced to set aside the GST consultation before the HKICPA announced its findings. This report made a significant influence on the withdrawal of the GST. This can be seen from the reports in the newspapers in Appendix 3 (South China Morning Post and The Standard are the major English newspapers in Hong Kong. The GST and the results of this survey were reported by all media but the Chinese newspapers clippings are not included in the appendix). One of the unexpected outcomes of the survey was that it caused a lawsuit between the accountants' representative in the Legislative Council and their representative in the profession, i.e. the HKICPA on the issue that the

Institute refused to distribute the GST survey and the Legislator's newsletter to accountants in her constituency (See appendix 3)

(b) On my personal professional practice

Another significant impact of this project is on my personal development and professional practice. It strengthened my research capability in problem solving. Professional practitioners are facing problems and have to solve them day by day. Some need a critical approach to solve for a long term benefit rather than a short term solution. Solutions found in a critical way are a means to build a practice's intellectual capital. In other words, the solutions will be an asset of the practice. This project enhances my research capability as well as my understanding of its importance for professional development, for a person or for a practice.

7.4 REFLECTION

My reflection in undertaking the Doctorate in Professional Studies (D. Prof) project is mainly in two aspects. One is the project content and the other is the programme itself.

The decision of taking a Doctorate degree is a long term commitment. The first issue I faced was to find a proper topic for this long term commitment. I have been practising tax for many years. Also, I conducted a survey on a GST in year 2002 and wrote articles on taxation in the Financial Post and newsletter of the CGA Newsletter. Sometimes, I made submissions to the Government on fiscal budget proposals and expressed our view on some tax issues. However, I have never made such in-depth study in the financial policy. The GST topic is particularly suitable for me because I experienced the impact of the tax on the economy when I migrated to Canada in 1990. The GST was just implemented there. This project enriches my knowledge in the Hong Kong economy, the underlying philosophy of the positive non-intervention and financial prudence policy, the financial system and the GST.

The programme is based on the Kolb's learning theory (Kolb: 1984), which the work-based learning studies programme is largely developed from and based on. It is undeniable that knowledge and work are intimately related. Huge of knowledge is hidden at the workplace and among the workers. The issue is how to transfer them to enrich our existing pool of knowledge and document them for further studies. There is limitation in transferring knowledge without "studies", which implies the stringent academic requirements including critical review of their learning and critical studies. This is an effective way to transform their hidden knowledge into formal learning. In other words, one can never get it right without integrating one's learning from experience with his or her academic learning. After all, it is the core of the learning-to-learn skill. People's knowledge is accumulated from work experience, especially their knowledge work and the theory derived thereon through the feedback and theory forming process. My project can never be completed and meet the academic requirements with my professional learning alone. It needs a process of extensive documentary search, literature review, in-depth studies of the economic policy and taxation theory. It is a well-mix of my learning from professional practice and academic studies.

-- End --

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ACKNOWLEDGEMENTS

I am very grateful for all the help and support I have been given in this project. I have to thank Prof. Derek Portwood who brought me the idea and rationale of Work-Based Learning Studies from which I learnt how professionals can acquire academic recognition through their learnt professional knowledge. In many ways this project represents a collaborative effort. I owe the Honourable Mandy Tam, the Legislative Councillor in Accountancy Functional Constituency of Hong Kong, who initiated the idea of carrying out a survey to examine the accountants' attitude towards the GST in the Hong Kong Special Administration Region. I thank Prof. Steven Li, (the Academic Director of the East Asia Work Based Learning Centre of Middlesex University), who agreed to carry out the survey in the Centre's name. Special acknowledgement is due to Mr. Metthew Harrison who gave me valuable comments on the questionnaires and the report; and my adviser, Prof. Jonathan Garnett who encouraged me to take the D.Prof programme and had advised me throughout the project.

Like most Doctorate candidates and project writers, this project cannot be finished without a supportive, tolerating and caring wife behind the scenes. This project is dedicated to her, she is wonderful indeed.

Appendix 1: Representative Sample Size

Sample size for $\pm 3\%$, $\pm 5\%$, $\pm 7\%$ and $\pm 10\%$ Precision Levels Where Confidence Level is 95% and $P=.5$.				
Size of	Sample Size (n) for Precision (e) of:			
Population	$\pm 3\%$	$\pm 5\%$	$\pm 7\%$	$\pm 10\%$
500	a	222	145	83
600	a	240	152	86
700	a	255	158	88
800	a	267	163	89
900	a	277	166	90
1,000	a	286	169	91
2,000	714	333	185	95
3,000	811	353	191	97
4,000	870	364	194	98
5,000	909	370	196	98
6,000	938	375	197	98
7,000	959	378	198	99
8,000	976	381	199	99
9,000	989	383	200	99
10,000	1,000	385	200	99
15,000	1,034	390	201	99
20,000	1,053	392	204	100
25,000	1,064	394	204	100
50,000	1,087	397	204	100
100,000	1,099	398	204	100
>100,000	1,111	400	204	100
a = Assumption of normal population is poor (Yamane, 1967) ¹ . The entire population should be sampled.				

Source: Glenn D. Israel (2003), "Determining Sample Size" University of Florida, IFAS

¹ Yamane, Taro (1967) "Statistics, An Introductory Analysis," 2nd Ed., New York: Harper and Row.

Appendix 2: (Questionnaires)

Dear fellow accountants,

Public consultation concerning the implementation of Goods and Services Tax (“GST”) is on the progress. The views of accountants are very important in this exercise. In order to collect opinions from accountants, ***East Asia Work Based Learning Centre of Middlesex University*** has kindly agreed to conduct a survey on GST. I should be most grateful if you could express your views on GST by completing the following questionnaire and sending it back to the Centre via one of the following:

East Asia Work Based Learning Centre, Middlesex University

Mail: 19/F., Tung Chiu Commercial Centre, 193 Lockhart Road, Wanchai. Hong Kong,

Email: GSTsurvey@mdxu.com.hk; **OR**

Fax : 2303 0212

*(Please mark “GST Survey” on the reply and return **ONLY ONE** copy of the questionnaire.)*

Your replies to the questionnaire will be kept confidential and used only for the purposes of the survey. The survey results will be published only in the form of aggregate statistics.

Thank you in advance for completing the questionnaire. I look forward to the results of the survey, which I am sure will provide valuable insights to the community.

Yours sincerely,

Mandy Tam

SURVEY QUESTIONNAIRE ON GOODS AND SERVICES TAX

PERSONAL INFORMATION

Your membership number and the accounting body you belong to*:

Accounting body: _____ Membership No.: _____

**The membership number will only be used to avoid double counting of responses but for no other purposes.*

1. You are:
☐ A. A Practicing Accountant ☐ B. A Non-practicing Accountant
☐ C. Retired/Unemployed
2. Have you ever lived in a country with GST/VAT?
☐ A. Yes ☐ B. No

TAX SYSTEM

3. Do you agree that there is a fundamental structural problem in the tax system? *(if (Yes), go to Questions 4 and 5, otherwise go to Question 6)*
☐ A. Yes ☐ B. Neutral
☐ C. No ☐ D. Don't know
4. If (Yes) to No. 3, which of the following is the major cause of the structural problem?
☐ A. The tax base is too narrow.
☐ B. Public expenditure is too high.
☐ C. Both of the above.
☐ D. Other suggestions:
5. If (Yes) to No. 3, is it necessary to introduce a new tax (i.e. GST) to solve the problem?
☐ A. Yes ☐ B. Neutral
☐ C. No ☐ D. Don't know
6. If there were a need to broaden our tax base, what would be the order of preference of the following [*1 = most preferred; 10 = least preferred (apply each digit once)*].

Order

 - A. Progressive Profits Tax Rate
 - B. Capital Gains Tax
 - C. Land Appreciation Tax
 - D. Goods and Services Tax (GST)
 - E. Sales Tax
 - F. Green Tax
 - G. Wealth Tax
 - H. Reduce Personal Allowance
 - I. Change the tax base to residency(i.e. rather than source)
 - J. Other suggestions

7. Do you think we need a comprehensive review of the current tax system?
- | | |
|---------------------------------|--|
| <input type="checkbox"/> A. Yes | <input type="checkbox"/> B. Neutral |
| <input type="checkbox"/> C. No | <input type="checkbox"/> D. Don't know |

GOODS AND SERVICES TAX (GST)

8. Do you agree to implement GST? *(If (Yes), go to Question 9, otherwise, go to Question 10)*

- | | |
|---------------------------------|--|
| <input type="checkbox"/> A. Yes | <input type="checkbox"/> B. Neutral |
| <input type="checkbox"/> C. No | <input type="checkbox"/> D. Don't know |

Give reasons, if any, _____

9. If you agree to implement GST, what tax rate do you think is appropriate? _____ %
10. Do you expect the introduction of GST to be revenue-neutral, i.e. that the Government will not generate additional tax revenue?
- | | |
|---------------------------------|--|
| <input type="checkbox"/> A. Yes | <input type="checkbox"/> B. Neutral |
| <input type="checkbox"/> C. No | <input type="checkbox"/> D. Don't know |
11. If the GST is set at 5%, what will the impact be on the Hong Kong economy?
- | | |
|--|--|
| <input type="checkbox"/> A. Favourable | <input type="checkbox"/> B. Neutral |
| <input type="checkbox"/> C. Unfavourable | <input type="checkbox"/> D. Don't know |
12. If GST is implemented, what do you expect the rate to be in five years' time?
- | | |
|------------------------------------|--|
| <input type="checkbox"/> A. Higher | <input type="checkbox"/> B. Unchanged |
| <input type="checkbox"/> C. Lower | <input type="checkbox"/> D. Don't know |
13. Do you have any other comments on GST?

~ End ~

Appendix 3

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----- Original Message -----

From: Reprint

To: Raymond Yeung (CPA)

Sent: Thursday, June 05, 2008 9:27 AM

Subject: RE: Use some newsclipping for Doctorate project

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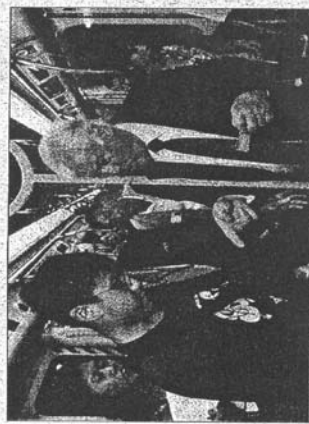
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A2 | HONG KONG & DELTA

MONDAY, JULY 24, 2006

SOUTH CHINA MORNING POST

Henry Tang faces an uphill battle to win public support for GST, warns Patten



Lord Patten rides a West Rail train yesterday. Photo: Martin Chan

Jimmy Cheung
and **Ravina Shamdasani**

Former governor Chris Patten said yesterday the finance chief had an uphill battle to win public support for his proposed goods and services tax.

A day after his speech with Henry Tang, Ying-ying about fiscal policy before the handover, Lord Patten said: "If Mr Tang could convince people in the next few months that there is a case for a sales tax, good luck to him. My impression is that it may be an uphill struggle."

On Saturday, Mr Tang said Lord Patten "patted his butt and left" in 1997, leaving the city ill-prepared for the Asian financial crisis that followed. Lord Patten responded by pointing out that Hong Kong's finances during his governorship were largely managed by Donald Tsang Yim-kuen, who is now Mr Tang's boss.

"I don't want to have an argument with him [Henry Tang], I barely know him. I'm far too old to get into this sort of face-slapping politics," Mr Patten told Cable TV. Lord Patten praised Mr Tsang for

his courage in fending off currency speculations during the Asian financial crisis, saying he would not have been bold enough to take such action during his rule.

These remarks were made during interviews with local television stations.

Lord Patten conceded that Britain should have implemented reforms for greater democracy in Hong Kong much earlier. He said even the reform package he introduced in the final years of colonial rule could not meet people's democratic aspirations today.

Asked if he agreed that the chief executive's ill-fated electoral package represented a step forward, he replied: "Maybe Donald was thinking of the hymn by Cardinal John Henry Newman, *Lead, Kindly Light*, and one line reads 'I do not ask to see the distant scene, one step enough for me'."

Meanwhile, Lord Patten turned on the charm for young people, commuters and fans gathering for his book signing.

At Mei Foo Koon West Rail course with the company's chief executive James Blake, Lord Patten

shared his love of books with secondary school children from the area as hundreds of people queued to receive their copies of his book *Not Quite the Diplomat* signed by the author.

Lord Patten joked about US President George W. Bush's G8 gaffes, saying that "the little mic" attached to his own lapel made him nervous, especially with Mr Bush getting into trouble recently for forgetting to turn it off.

He said Hong Kong was still as it was before 1997 - free, safe and "one of my favourite cities".

Source: South China Morning Post 24 July 2006

"GST would spur public spending"

"It is socially inequitable because a sales tax is by definition regressive"

"It is regressive by nature irrespective of the income level and people's affordability."

Lord Patten (Chris Patten), the last governor of Hong Kong.

Source: South China Morning Post 8 August 2006

HONG KONG

SOUTH CHINA MORNING POST

Thousands join Liberal Party's march to protest against GST



Photo: Edward Wong

Demonstrators from more than 40 organisations gather in Chater Garden yesterday morning before marching to the government headquarters chanting slogans against a proposed goods and services tax.

Agnes Lam

Thousands of people from the catering, retail and logistics industries joined a march organised by the Liberal Party to protest against the proposed goods and services tax yesterday.

About 6,000 demonstrators attended the event, the party said, but police put the figure at about 2,900. Party vice-chairwoman Miriam Lau Kin-ye said there would be a

continuing campaign to voice the concerns of the business sector in the coming months.

"The proposed tax is a big blow to all kinds of industries and may even totally ruin their business. The city's economy will be seriously affected and unemployment might be worsened," Ms Lau said.

Protesters from more than 40 organisations gathered at Chater Garden at 10am before marching to the government offices. They chanted

slogans: "Say no to GST" and "GST No way" along the route.

A petition urging the administration to broaden its tax base by exploring other measures was handed to a government representative.

Executive council member Selina Chiu Liang Shuk-ye, who only attended the gathering at Chater Garden, said she was not in a position to join the march.

"As a politician, I only collect votes from the protesters," she said.

Secretary for Financial Services and the Treasury Frederick Ma Si-hung said GST had been implemented in more than 135 jurisdictions.

"The proposals put forward in the consultation document are no meant to be conclusive, but are intended to stimulate rational and informed discussion on this subject," he said.

"We expect that our experience should be similar, producing no marked effect in the short term, while in the long run the effect will

be positive," he said. A government spokesman said it welcomed community views on tax reform and proposals in its nine-month consultation document.

"The proposals put forward in the consultation document are no meant to be conclusive, but are intended to stimulate rational and informed discussion on this subject," he said.

■ Preparations for a rainy day - A11

Source: South China Morning Post 18 September 2006
A2 | **HONG KONG & DELTA**
MONDAY, SEPTEMBER 18, 2006

Accountants voice strong opposition to sales tax

Only 31pc of those polled say they are in favour of a goods and services levy

Jimmy Cheung and Winnie Yeung

Accountants have shown strong opposition to a goods and services tax, with nearly two-thirds of respondents to a survey rejecting the government's proposal.

Sixty-two per cent were against a GST, compared with 31 per cent in favour, according to the survey commissioned by the Legislative Council's accountancy representative, Mandy Tam Heung-man.

The Civic Party legislator sent questionnaires to 26,000 accountants last month and had received 311 responses by Friday.

Most did not see the need for a GST, but 63 per cent agreed with the government that there were problems in public finance.

Among those who agreed there was a structural problem with Hong Kong's public finances, 48 per cent opposed a GST, while 45 per cent were in favour.

Eighteen per cent said high government spending was the biggest problem, while 34 per cent pointed to the narrow tax base. Forty five per cent pointed to both factors.

Six out of 10 did not believe the government would honour its pledge that revenue generated from a GST would be offset by other tax concessions.

Only 28 per cent believed it would stay revenue-neutral.

Ms Tam said the administration should first control public spending and raise work efficiency.

"The government should explore other ways to broaden the tax base," she said, referring to the respondents' preferences for other

methods of raising money, such as a progressive profits tax and capital gains tax.

Defending the consultation on a Commercial Radio programme yesterday, executive councillor Ronald Arculli said politicians lacked the vision to tackle long-term problems.

He believed parties recognised problems facing Hong Kong, like an ageing population and pressure on public spending, but many shot down proposals immediately because of public opposition.

He also hit back at claims that the government would rely on the surplus in the Exchange Fund instead of widening the tax base. He said the Exchange Fund served to stabilise the currency and the finance system.

"We don't know whether it will take three years or five years for the Chinese yuan to de-link. What would be the impact on the Hong Kong dollar?" he asked.

Increasing the rates levy would not be feasible either, he said, as ratepayers would then face the prospect of a twofold increase in bills to match the amount that would be raised by a GST.

Another survey showed that about 70 per cent of teachers objected to a GST and they would spend less after the tax was introduced.

The Hong Kong Women Teachers' Organisation interviewed 657 teachers this month. Half said they would have less money to save and invest if the tax was introduced, while 11 per cent would consider delaying their retirement.

Appendix 3 (continued)

Critisms of the survey on the low response rate.

Metro
M01

The Standard
英文虎報

Albert Wong
2006-09-18

Backlash over GST survey

Accountant body disagrees with lawmaker on tax

The Hong Kong Institute of Certified Public Accountants has hit out at legislator Mandy Tam Heung-mai's survey of accountants on the proposed goods and services tax as being "not meaningful." Tam, who represents the accountancy sector in the Legislative Council, Sunday broke out of line with the institute and declared that most of her constituents are against a GST, following the response so far from a survey, which began last month.

But HKICPA president Paul Chan Mo-po said that, in past years, the institute has made submissions to the financial secretary before his budget speech, calling for consultations on a possible GST, saying it was the best way of broadening the tax base.

He said many accountants had yet to understand the details of the government's plan. A "yes" or "no" answer without a detailed understanding of the GST was "not meaningful," he said.

This is not the first time Tam has broken out of line with the views of the HKICPA. In December a survey by the institute found that 53.9 percent of its members (1,452 people) wanted Tam to vote for the government's political reform package. She voted against it, nevertheless, in line with the Civic Party.

Tam released the results of a survey she sent to all 26,000 of the territory's accountants, showing that 62 percent of the 311 respondents oppose the proposed tax, with only 31 percent agreeing to it.

"This dispels the myth that the accounting sector would support the tax because it would give them more work," Tam said. "They don't just think about their personal interest. They also think about the public interest."

18/9/2006

Frankie Yan Man-sing, an accountant who helped with the survey, said that from his experience working in Britain where there is a similar value-added tax, the extra work was tedious, requiring a lot of effort, with little benefit for accountants.

But Chan, who did not respond to the survey, drew attention to the relatively low response rate of 311 and questioned whether the survey was representative of the whole sector.

He said the institute was in the process of setting up a dedicated Web site and is inviting individual members to comment. It also hopes to submit a more detailed submission to the government before the end of the year. Only then, after accountants have a better understanding of the proposal, would it be the "appropriate time" to make a statement on behalf of them, Chan said.

James Sung Lap-kung, a political analyst at City University, also questioned the 62 percent figure as "dubious." But Sung said Tam, despite her differences with the HKICPA, still had a solid support base among the territory's accountants.

Victor Wai Chi-kin, another accountant who helped with Tam's survey, said it was not the sample size of respondents that mattered, but the sample type, and he asserted the respondents were not from a "biased pool."

Tam said the survey showed that accountants had a good understanding of the issues. Of the 311 respondents, 47 percent had experience of a jurisdiction with a goods and services tax.

The respondents ranked the GST the fourth-best option for helping broaden the tax base, behind profits tax, land appreciation tax and capital gain tax. Tam concluded that accountants wanted a broadening of the tax base, but did not think a GST would be the right option.

Yan said: "At the end of the day, we accountants are still part of the middle class, part of the public" and think the GST unfair since everyone will have to pay the extra tax, but only the higher-income groups receive the benefits of a salaries or profits tax break.

18/9/2006

Sung also dispelled any speculation that Tam was planning to abandon the accounting constituency and run for a geographical seat in the next elections. Since Tam is the only one from the pro-democracy camp contesting the functional constituency, other candidates often cancel each other out, leaving Tam the clear favorite and making the accounting sector an attractive seat for her, Sung said.

Tam encouraged accountants to continue sending in replies to her survey, emphasizing that Sunday's release was not the final result. However, she said she and five other Civic Party lawmakers will vote against the GST.

Meanwhile, executive councillor Ronald Arculli urged the public to participate in the consultation process, and criticized opponents of the tax for only counting their votes, and not thinking of the future with good policy sense.

albert.wong@singtaonewscorp.com

文章編號: 200609184480029

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A simple GST will offer little financial benefit to profession

UNDER THE GOVERNMENT'S proposed goods and services tax, financial services will be zero-rated. This means they are exempt from the tax.

At the same time, financial institutions will be able to claim back GST on their purchases.

"The GST proposal, as it stands, should not affect Hong Kong's position as a leading financial centre, not forgetting that this leading status also depends on our infrastructure and rule of law," said Tim Lui Tim-leung, a tax partner at PricewaterhouseCoopers.

"As long as GST does not affect these things, we should be fine," he said.

Mr Lui is a member of the Advisory Committee on New Broad-based Taxes. The committee made its report in 2002 after studying different tax options, including tax on dividends and higher salaries tax.

"When we did our work it was at a time when the government was in serious deficit and our remit was to examine taxes that could raise revenue. On a longer-term basis, GST was a possibility," he said.

"On a short-term basis we singled out three things – reducing personal allowances, increasing the tax rate and introducing a land and sea departure tax."

Financial Secretary Henry Tang Ying-yan has been pushing hard for the implementation of GST.

For accountants, the impact of a GST on their daily business goes hand in hand with the complexity of its regime. The proposed system has no exemptions and would therefore be administratively easier to implement, as there would be fewer disputes than under a more complex regime.

Big businesses would probably fare better than small and medium-sized businesses (SMEs), even if the latter were given exemptions. Compliance could be



Financial Secretary Henry Tang is pushing hard for tax. Photo: Robert Ng

helped by IT solutions, and prior experience of similar taxation in other jurisdictions would help.

Mr Lui said SMEs, however, were still likely to face difficulties.

"Any additional administrative cost or outlay of expenditure might cause some financial burden to SMEs," he said. "That's why I think the government is thinking about giving SMEs a grant at the point of implementation so that they can have some financial assistance in terms of potential set-up costs."

Taking care of SMEs is of paramount importance under any GST regime, as these businesses represent more than 98 per cent of total establishments and provide job opportunities to more than half the workforce.

Mr Lui said compliance costs would be about HK\$5,000 to HK\$6,000 a year, based on international experience.

"In Australia, it costs between A\$500 and A\$800 [HK\$2,900 to HK\$4,700] to comply each year, and in Singapore about S\$1,000 [HK\$4,900]. Once you take care of the initial set-up costs, the ongoing costs are not that much,

unless you have to hire more people."

Any GST regime – complex or otherwise – will, of course, mean work for accountants. Even a reasonably straightforward system with few exemptions will provide them with initial advisory work.

"Experience elsewhere suggests that if you keep the GST fairly simple, accountants may be asked to help out in terms of advisory roles, but the implementation of the tax is not a licence to print money," Mr Lui said.

"If the system is simple enough, this is not going to be big dollars for the accountants," he said. In other jurisdictions where the system is complicated and the tax rate is high, then yes, a segment of accountants are fully occupied because of the complexity of the rules and principles.

"But so far, what is being proposed in Hong Kong avoids this complexity. And on the basis that we are going to operate a fairly straightforward system, the accountants are not going to be in it for big money," he said.

Source: South China Morning Post 28 Sept 2006

Lawmakers opposed to GST short-sighted, minister says

Denise Hung and Jimmy Cheung

The war of words over the goods and service tax escalated yesterday after a senior government official accused lawmakers of being short-sighted and irresponsible in blocking the proposed levy.

Secretary for Financial Services and the Treasury Frederick Ma Si-hang said people opposing the GST should look beyond their own interests, adding that there needed to be a solution to the narrow tax base and ageing population.

He insisted the consultation on the GST would continue until March as planned, even if lawmakers were poised to pass a motion against the proposed tax on Wednesday.

The remarks came as the government prepares, in a bid to counter unfavourable public opinion, to release detailed examples of how taxpayers could be better off in other areas after the GST is introduced.

The government has estimated a 5 per cent charge would bring net revenue of HK\$20 billion a year. Officials have pledged to reduce profits and salaries taxes as a trade-off.

Mr Ma, speaking on Commercial Radio, attacked lawmakers for rejecting the GST, saying it was a vote-grabbing exercise.

"Sometimes I think our lawmak-



Frederick Ma: "If people just focus on themselves, who's going to work for the common good?"

ers are too short-sighted," he said. "I even dare say they do that for votes. It would be irresponsible to make us shelve the consultation."

While he said it was understandable that people would object to new taxes, he hoped the public would not just focus on their own interests.

"If people just focus on themselves, who's going to work for the common good?" he asked.

Democratic Party legislator Albert Ho Chun-yan said the government did not know what impact the GST would have on the poor.

"The gap between the rich and poor is getting bigger and yet Mr Ma has failed to appreciate that. Who's lacking vision?" he said.

Liberal Party vice-chairwoman Miriam Lau Kin-ye said Mr Ma had no grounds to attack lawmakers. She said opinion polls showed public opposition had risen from 60 to nearly 80 per cent over the past few months.

On Wednesday, the three key voting blocs in the Legislative Council – the Democratic Party, the Liberal Party and the Democratic Alliance for the Betterment and Progress of Hong Kong – are expected to support a motion rejecting the GST.

Although the motion is not legally binding, the united front will put the government in a difficult position.

Democratic Party legislator Yeung Sum, who is tabling the motion, said opinion against an "unfair" GST was clear and the gap between the rich and the poor was increasing.

Meanwhile, Legco banking representative and executive councillor David Li Kwok-po will table an amendment saying the consultation should continue. His amendment also suggests the council oppose the GST if there are other feasible options acceptable to the public for broadening the tax base.

A government official said: "The community should have a rational discussion on how to widen the tax base if not to introduce a GST."

■ Frederick Ma fuels speculation – A3

AY	SECTION A	BUSINESS	SECTION B	CITY • LIFE • SPORT	SECTION C
ar	A2	Companies & Finance	B2-3	City News	C1-5
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ational	A10-17	Mutual Funds	B13	Diversions, TV & Radio	C11-12
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t	A19	Hong Kong Stocks	B16	Soccer	C16 & 18
Features	A20	Monitor	B18	Baseball	C17

Source: South China Morning Post 4 October 2006

Open season as accountants take on Legco member

After smouldering for two years, the hostility between the people who run Hong Kong's accounting certification body and Mandy Tam Heung-man, the accountants' representative in the Legislative Council, has broken into the open.

A source at the Hong Kong Institute of Certified Public Accountants tells *White Collar* that the body plans to announce today that it will no longer distribute Ms Tam's newsletter to its 26,000 members.

The institute also intends to hit back at some of the criticisms that Ms Tam, a member of the democratic camp in the Legislative Council, has been voicing in her columns in the Chinese press. Among other things, she has said that the institute's examinations are too difficult and demanded that it survey its members on the government's proposed goods and services tax, which she opposes.

"Enough is enough," our source said. "The institute has kept a low profile for a long time but Ms Tam has been questioning our integrity in her columns and her newsletter. We think we need to tell our side of the story."

"The HKICPA considers it is time to distance itself from politics so we have decided not to distribute her newsletter together with ours to prevent the members from mixing them up. This is not to say that our relationship with Ms Tam is totally over but we would prefer to co-operate with her in different ways."

Readers will know that Ms Tam and the institute have clashed often since she defeated its president Paul Chan Mo-po by a razor-thin margin of 36 votes in the Legco functional constituency elections two years ago.

Their first public spat was over her insistence that the institute post her newsletter along with its own to all local accountants. The institute countered that it would send 10,000 copies by post and the rest by email to its members who had opted for electronic delivery. The institute finally agreed to post Ms Tam's publication to all members after she agreed to pay the HK\$30,000 postage costs.

In some bean-counting circles, Ms Tam's newsletter is deemed to be too political. Her opposition to the goods and services tax has raised some hackles.

Leaders of the institute don't plan to do a survey on the issue at Ms Tam's behest.

"It should be the institute that decides how and when to do its survey," the source said. "Ms Tam can do her own any time she likes."

The source said that the institute's survey, when it comes, will be more than a simple yes or no exercise. It will weigh in on the question of tax rates and exemptions too. The institute

White COLLAR

Enoch Yiu



plans to submit a position paper to the government before the GST consultation period ends in March.

Source:

South China Morning Post

10 October 2006

IN BRIEF

LEGISLATORS LODGE PETITION FOR JOURNALISTS' RELEASE

A petition signed by 45 legislators calling on President Hu Jintao (胡锦涛) to release jailed Hong Kong journalist Ching Cheong on medical parole was sent to Chief Executive Donald Tsang Yam-kuen yesterday. Democrat Cheung Man-keung, who initiated the campaign, said he was touched by the case as it far exceeded the 35 signatures gathered in a similar campaign calling for a fair trial for Ching in August. Besides the pan-democrats, signatures came from the Democratic Alliance for the Betterment and Progress of Hong Kong and the Liberal Party.

STUDY ON LANTAU LOGISTICS PARK ALMOST COMPLETE

A feasibility study on a HK\$1.3 billion logistics park on Lantau Island will be completed in the first quarter of next year, but the construction will still take the next two years to complete, according to the government said yesterday. The 75-hectare project, proposed in 2000, is intended to complement the Hong Kong-Zhuhai-Macau bridge and Container Terminal No 10, but the latter two projects do not have a completion date.

COURT RESOURCES CENTRES TO CLOSE ON SATURDAYS

The resource centre for unrepresented litigants and the information and inquiry counters in the city's top court building will close on Saturdays next year in a move to save costs. The move will close on Saturdays a five-day week for judicial staff. From January 1, the Court of Final Appeal and District Court libraries, High Court and Court of Final Appeal information services and the complaints office will close on weekends.

FEMALE REPRESENTATION LIMITED, SAYS PATRICK HO

Fewer than half of the 369 government advisory and statutory bodies with appointed non-official members have 25 per cent or more seats occupied by women. Patrick Ho, Secretary for Labour and Manpower, said the Legislative Council that 180 out of 369 non-officials had 25 per cent or more female representation.

Land and sea departure levy may be key to broader tax base

Treasury chief says government looking at options after shelving of GST plan

Dennis Ng

The government may re-evaluate the tax base by introducing a land and sea departure levy as a way to broaden the tax base, but further increases in the corporate tax rate have been ruled out.

Secretary for Financial Services and the Treasury Frederick Ma Si-hang said yesterday that as the government has adopted a prudent fiscal policy, it was open to discussing suitable alternatives, including the shelved departure tax.

"We're not going to pursue the GST for now so we can continue to discuss this option," Mr Ma said of the departure tax, speaking on RTHK.

Departure tax was first introduced four years ago by then financial secretary Antony Leung Kuan-chung, who made the proposal amid ballooning budget deficits. It was estimated at the time that the government would reap roughly HK\$1 billion a year if a departure tax of HK\$10 was imposed on travellers leaving Hong Kong by land or sea.

The proposed levy was opposed by the business community and, a year later, the government decided not to pursue it.

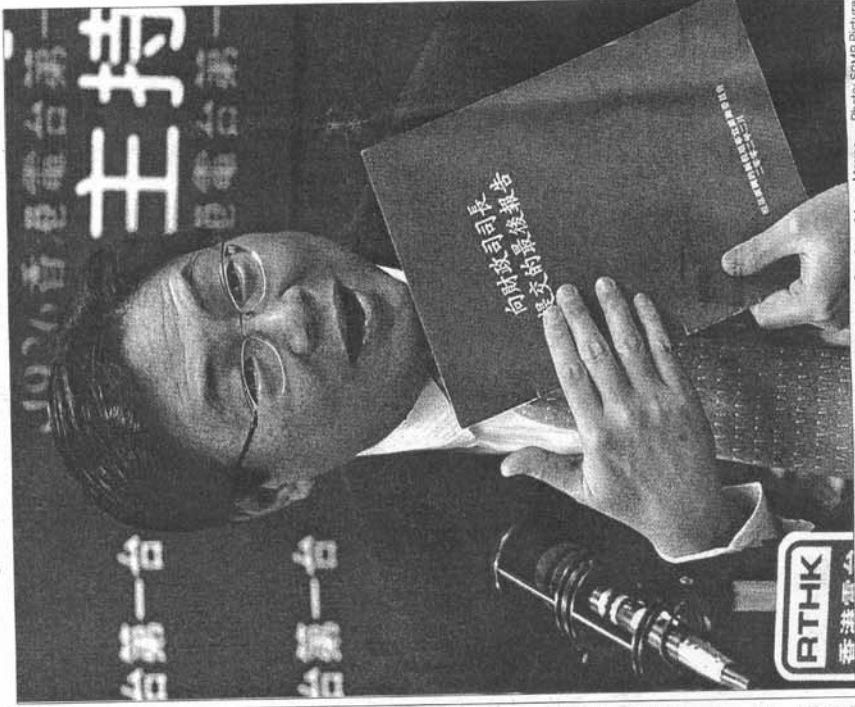
According to data from the Immigration Department, passenger traffic by land reached 135.9 million last year, up from 135.9 million in 2004. The figure was 21.5 million last year and 21.4 million the year before.

Mr Ma's remarks followed Financial Secretary Henry Tang Ying-yan's announcement on Tuesday that the government would stop promoting a GST as the solution to the macroeconomic problem. The announcement was not sudden, insisting the administration had been contemplating the move for quite some time.

Mr Ma also dismissed suggestions that the decision was spurred by remarks made by National People's Congress chairman Wu Bang-xian.

Mr Ma's remarks followed Financial Secretary Henry Tang Ying-yan's announcement on Tuesday that the government would stop promoting a GST as the solution to the macroeconomic problem. The announcement was not sudden, insisting the administration had been contemplating the move for quite some time.

Mr Ma also dismissed suggestions that the decision was spurred by remarks made by National People's Congress chairman Wu Bang-xian.



Frederick Ma yesterday highlights a 2002 study by an advisory panel on broad-based taxes. Photo: SCMP Picture

Court grants hearing in minimum wage battle

Klaudia Lee

A judge has accepted an application for a judicial review of the government's refusal to introduce minimum wage legislation.

Mr Justice Michael Hartmann granted leave for the application filed by 51-year-old cleaner Leung Yiu-tung, and legal counsel Leung Yiu-tung, "Tung Hair" Leung Yiu-tung, to be heard.

The applicants want the Court of First Instance to reverse Chief Executive Donald Tsang Yam-kuen's decision to rely on the co-operation of employers to set minimum wages, rather than legislate.

Leung Yiu-tung said he would seek aid today and hoped for a speedy hearing.

"It's highly likely that the Legal Aid Department will grant the legal aid because the judge has already granted leave for the case and the applicant's financial status is such as the criteria under the aid is granted," Leung said.

"When the case is heard in court, it will raise awareness not only about the enactment of legislation on a minimum wage but also whether the government has failed to act under the Trade Board Ordinance, enacted in 1940, to regulate minimum wages."

Leung said that the judge had granted leave so soon after the application for judicial review was filed could be seen as recognition of the issue was of huge public interest, the legislator said.

In the writ filed by the applicants on Monday, it is alleged that the government failed to pay the work for a minimum wage. The government's refusal to pay the work for a minimum wage was so low and work conditions so poor that the chief executive should use powers conferred on him by the ordinance to establish minimum conditions and pay for her industry.

She earns HK\$3,400 a month for a 10-hour day and has only four days off.

Ordinance states its purpose is "to provide machinery for fixing minimum wages, determining normal working hours, and fixing overtime rates in trades where the wage standards are unreasonably low".

We've not won over the majority, says finance chief, but denies sales tax decision is tied to Election Committee vote

Tang pulls plug on GST, saying time is not right

Robin Kwong and Denise Hung

In a sudden about-turn, Financial Secretary Henry Tang yesterday shelved the goods and services tax, saying the government would stop advocating the levy during the remaining four months of its consultation on tax reform.

The announcement marked the end of the government's months-long battle to rally the community behind the controversial GST, which has faced challenges from some of Mr Tang's former allies and seen a dip in his and the government's popularity.

The timing of the announcement fuelled speculation of possible political intervention, as it came just after the visit by National People's Congress chairman Wu Bangguo (吴邦国) to the city and days before Sunday's poll to return the 800-strong Election Committee that will choose the next chief executive.

Mr Tang said after an Executive Council meeting yesterday that the decision was a result of an interim review of the nine-month consultation, which began in July. Opposition to a GST had stood at a constant level of more than 60 per cent in recent months, he added, at a press briefing later.

Asked about the views collected, he said he had not been able to convince the majority to accept a GST as the time had not yet come to address the tax base issue, he said.

"We accept that at this time there is insufficient public support, nor are the conditions right for introducing a GST."

Mr Tang insisted that the timing of his announcement had nothing

A final report will be drawn up next March.

Chief Executive Donald Tsang Yam-kuen said he and all Exco members supported Mr Tang's decision.

Political parties generally welcomed the move, which a government source said had been contemplated since last month.

Legislative councillor and Exco member Tsang Yok-sing, of the Democratic Alliance for the Betterment and Progress of Hong Kong, said it was "a wise decision" to abandon the proposal.

Liberal Party lawmaker Vincent Fung, who chairs the Coalition Against Sales Tax, said the decision would provide a boost to the retail and tourism sectors.

Unionist Lee Cheuk-yan, a member of the Fair Tax Alliance, said the government should conclude the consultation now instead of waiting until March.

Sources close to Beijing said the levy proposal was doing harm to Mr Tsang's bid for re-election and was not conducive to building social harmony, which was a major objective of Beijing underscored by Mr Wu during his visit at the weekend.

"Wide public support for the government as a whole is instrumental to ensuring Donald Tsang's re-election and his implementation of strong governance," one source said.

Political analyst Ma Ngok, of Chinese University, said the effect would be minimal because those most affected by the decision, such as the retail, wholesale and commerce sub-sectors were already inclined to vote for Mr Tsang.



to do with politics. "The GST has nothing to do with foreign affairs or national defence. It is a government decision for Hong Kong under the principles of 'one country, two systems' and a high degree of autonomy enshrined in the Basic Law."

Pressed on whether the move was related to Sunday's election, Mr Tang said: "I don't feel that this should have anything to do with the election. I cannot see why someone would cast a vote for any particular candidate because of our decision on GST."

He insisted the government had done the right thing in launching the consultation on the controversial tax, and stressed it was also correct to follow popular opinion in dropping the proposal.

It is of equal importance to govern for the people and adhere to public opinion, he said.

People were welcome to comment on other options for tax reform during the remainder of the consultation period, Mr Tang said.



Henry Tang explains his reasons for shelving the widely opposed GST. Photo: SCMP Picture

"I feel that with the robust growth, moderate inflation and relatively low unemployment it is the right time for a discussion"

Henry Tang launching consultation on July 18

"We feel that a GST is the best option to broaden our tax base to meet the community's future fiscal needs"

August 25

"The motion will scuttle discussion. I hope [Legco] members' misinterpretation of public opinion will not strip society of an opportunity to discuss a very important subject"

October 19, after Legco passes motion rejecting GST

"We accept that at this time there is insufficient public support, nor are the conditions right, for introducing a GST"

Yesterday

Appendix 3 (continued)

文章總數: 1 篇

EDT
EDT2

南華早報

AMBROSE LEUNG
2006-12-15

Accountants propose alternatives to GST

A land and sea departure tax, a capital gains tax or an income tax levied on Hong Kong citizens worldwide should be considered as alternatives to broaden the tax base, Hong Kong accountants say.

The Hong Kong Institute of Certified Public Accountants said nearly 60 per cent of accountants who took part in an opinion poll said they were opposed to the introduction of a goods and service tax, which has now been shelved by the government.

For the survey, carried out last month, the institute sent out about 20,000 questionnaires to members and received 1,980 replies. The percentages are of that number.

Fifty-nine per cent of those said they were opposed to a sales tax while 35 per cent indicated their support. A clear majority of 77 per cent said Hong Kong was facing financial problems, and 64 per cent said there was a need to broaden the tax base.

Accountants were asked to choose several tax options they favoured, with 62 per cent selecting a land and sea departure tax; 46 per cent choosing a capital gains tax; 37 per cent a retail and wholesale tax; 36 per cent a worldwide income tax; and 34 per cent a GST.

Sixty-five per cent of respondents believed the current level of government spending was too high.

The findings have put the institute in an embarrassing situation, as it had long pushed for the introduction of a GST.

A survey carried out by accounting sector legislator Mandy **Tam Heung-man** with similar findings was dismissed by critics as non-representative. Both surveys were conducted before the government shelved the GST proposal this month.

Paul Chan Mo-po, president of the professional body, said the government must follow up the issue of broadening the tax base. Donald Tsang has made a brave decision to consult the public on a GST, which the institute still thinks is a best option, Mr Chan said.

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文章編號: 200612150270051

Source:

South China Morning

Post 15 December 2006